

Medical Savings Accounts

A How To Guide for Ohio Businesses and Employees

Executive Summary

Currently, Medical Savings Accounts (MSAs) are used by more than 2,000 companies nationwide. This number is likely to increase significantly now that the federal government has implemented a pilot program allowing up to 750,000 firms to establish tax-free MSA plans for their employees. Additionally, states, including Ohio, have passed legislation exempting MSAs from state income taxes.

Both employees and employers can benefit from MSAs.

Employee Benefits

- **Reductions in out-of-pocket costs.** An analysis 400 firms found out-of-pocket costs fell by \$954 on average for families using MSAs.
- **Savings for future health care expenses.** Up to 70% of employees may have funds remaining in their accounts at the end of the year.
- **Access to more health services.** Twenty-seven percent of employees in one company used new health services using their MSA funds

Employer Benefits

Employers benefit through lower total plan costs, usually in the range of 12% to 40%. Cost savings for businesses result from:

- **lower premium costs** since employees are insured under a high deductible insurance policy above the cash value of the MSA.
- **cost conscious shopping** by employees to maximize the value of their account at the end of the year.
- **substantially reduced administrative costs.**

Setting up an MSA

The report outlines the necessary elements for setting up an MSA, including:

- the size of the MSA deposit.
- the deductible for supplemental insurance.
- what services will be counted against the high-deductible insurance policy.
- out-of-pocket exposure for covered employees and families.
- rules for pre-existing conditions.

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I. Redefining Health Insurance in America

Imagine a health care plan that allows employees to purchase the health care services they want, and then gives them money back at the end of the year. This plan also reduces employer health insurance expenses and gives workers more, not fewer, choices over doctors, hospitals, and treatments.

Sound far fetched?

Not if someone works for Danville City Schools in Ohio, Dominion Resources, Golden Rule Insurance Company, Jersey City, *Forbes Magazine*, Ohio Window Cleaning Company, the Swanson-Reddinger Corporation, Rockbridge Community Services, and any of the more than 2,000 companies that offer Medical Savings Accounts (MSA's).¹ More than 30 of these firms are located in Ohio.²

MSAs are an alternative to traditional health care plans that have become very popular with employers and employees.

Conventional health care plans

MSAs are quite a contrast to conventional forms of health insurance. Traditional and managed care plans attempt to control costs by limiting health care choices and reducing the patient's role as consumer.

They often have low deductibles and co-payments. This reduces the amount an individual spends out of his own pocket for health care. The funding comes from the insurance company or the employer through premiums. Traditional plans, in effect, use "other people's money."

Basic economics takes over here: if they pay less, consumers will want more of a product.

Not surprisingly, after the dramatic expansion of low deductible health insurance plans through employment and the enactment of Medicare and Medicaid (government programs based on the same principles), health-care spending in the U.S. exploded.³

Managed care plans emerged to restrain these rising health-care costs. Managed care essentially "rations" health care by giving doctors financial incentives to see patients less frequently.⁴ These programs thus restrict the health-care choices of patients and transfer decisionmaking authority to insurance companies and managed care administrators. The patient, in this system, has little to say about who they see or what treatments they can use. Proponents of managed care argue that reduced patient choice is the price of controlling health care costs.⁵

The MSA alternative

Medical Savings Accounts take the opposite approach to controlling health-care costs. They recognize that escalating costs are driven in large part by patients who act as if they were not spending their own money. Patients have little incentive to be "smart" health care shoppers under the traditional system. Traditional plans reduce individual patient costs to the point that they discourage looking for the best health care for the lowest cost. Managed care plans effectively remove consumers from making health care choices. In either case, the insurance company or the employer pays all but a small fraction of the cost of health-care services.

MSA's reverse these incentives by allowing patients to benefit directly by reducing health care expenses (see box on page 3). MSAs allow employers to buy high-deductible health insurance policies to cover costly health-care expenses. The employer then deposits all or part of the premium savings (typically \$1,500 to \$2,500) into an employee-owned Medical Savings

Account. This money is used at the employee's discretion for low cost and routine health-care expenses. Money left over at the end of the year is usually rolled over into the next year as a hedge against future health care costs or withdrawn as cash.

Where MSA's have been adopted, the results have been dramatic, for both employers and employees.

Purpose of this guide

But, on a concrete level, how do MSA's work? Who really benefits? How would a firm set one up?

This guide helps answer these questions for employers and employees.

The next two sections outline the benefits of MSAs to employees and employers. The fourth and fifth sections discuss critical issues and decisions employers and employees must make when they consider developing an MSA. We have also attached, as Appendix A, a series of common questions and answers about MSAs to help clarify some of the main benefits and features of MSA plans.

The Mechanics of MSA's

How does an MSA work? The following is an example based on a real-world case.

First, consider a traditional health insurance plan. Suppose a firm has a family plan with a \$400 deductible and a 20% co-pay on the next \$2,500 in health-care spending. Once the employee hits \$400 in expenses, the family will have to contribute \$20 for each additional \$100 of health-care expenses. In addition, the employer requires the employee to pay \$300 of the plan cost (e.g., \$25 per month for partial premium payments) regardless of how much he or she uses. Under this plan, an employee who uses no health care during the year will pay \$300. An employee who is quite sick will have a maximum out-of-pocket cost (OPC) of \$1,200. If the employer pays an annual \$5,000 premium, the total plan cost will be \$6,200 per employee.

An MSA plan is set up differently. It has two basic components. The first covers expensive health care. The employer might purchase a health insurance policy with a very high deductible, say \$3,000, that ensures 100% coverage of expenses over that amount. This type of plan costs much less than the more traditional plan because the insurer is responsible for fewer expenses, given the high deductible. So, the employer's insurance premium would fall from \$5,000 to about \$2,600.

The second part of the plan is the actual MSA. The employer funds a health-care expense account (the MSA) of \$1,800. This account would be used for low-cost and routine health-care expenses. In this case, the employee who uses no health care will have \$1,800 left over at the end of the year. In fact, since the traditional plan also requires a \$300 contribution from employees, the employee is actually better off by \$2,100 under the MSA plan.

Traditional Insurance Compared to MSAs

Traditional Plan MSA

Insurance Plan Deductible (maximum) \$ 400 \$ 3,000

Maximum Co-Pay 500 0

Premium (employee share) 300 0

Maximum Out-of-Pocket Cost (employee) 1,200 1,200

Premium (employer share) 5,000 2,600

MSA Deposit (employer) 0 1,800

Maximum Plan Cost \$ 6,200 \$ 5,600

What if an employee becomes ill and uses \$1,800 for health-care services, the amount of the MSA? The entire amount would be paid by the MSA. Under the traditional plan, by contrast, the employee faces out-of-pocket costs of \$940 (\$300 contribution + \$400 deductible + 20% of \$1,200). Under the MSA, the employee has not incurred any out-of-pocket costs not fully covered by the MSA. The employee is better off by \$940 under the MSA even if she is ill.

II. How Employees Benefit from MSA's

Employees are potentially big winners under MSA plans

MSAs can reduce out-of-pocket exposure

One of the biggest advantages of MSA's is that they can reduce out-of-pocket costs for employees while providing a direct cash pay-off for being healthy.

Figure 1 (on page 5) compares the out-of-pocket costs for employees under a traditional health insurance plan with those under an MSA plan. The data are based on a real organization that already uses MSA's.

Under traditional plans, employees begin paying out of their own pockets immediately. Traditional plans typically require employees to meet a deductible and contribute a portion of the premium cost of the plan (see box on page 3).

Potential Uses of MSA Savings

- Hedge against future expenses
- Retirement

- Long-term health care
- Savings
- Cash

Under an MSA plan, employees begin paying for health care expenses out of an employer-funded health care account.

Suppose an employer provides her employees with an MSA worth \$1,800. The MSA amount is deposited annually into an account for the employee's use. If the employee uses \$1,000 of health services during the first year of the plan, he will have \$800 left over at the end of the year.

What this \$800 can be used for will depend on how the plan is set up. Some companies, such as the Golden Rule Insurance Company, allow employees to withdraw their end-of-the-year savings for any use they want. Under the new MSA law passed by Congress, withdrawals for non-medical expenses are taxed as ordinary income and are subjected to a 15% penalty.

Under a plan proposed by the Ohio Department of Health for state employees, end-of-the-year savings would be rolled over into the next year to cover future health care expenses, or into a long-term health care account.⁶ Companies could also have end of the year savings rolled over into retirement accounts.

Under MSA plans, employees will not be exposed to out-of-pocket expenses until they exceed the amount of the MSA deposit for that year. If an employee's family had health expenses of \$4,000 during the year, the first \$1,800 in expenses would be paid by the MSA deposit for that year. The next \$1,200 would be out-of-pocket expenses not covered by the MSA. Above \$3,000, a high-deductible insurance plan kicks in and covers all further expenses.

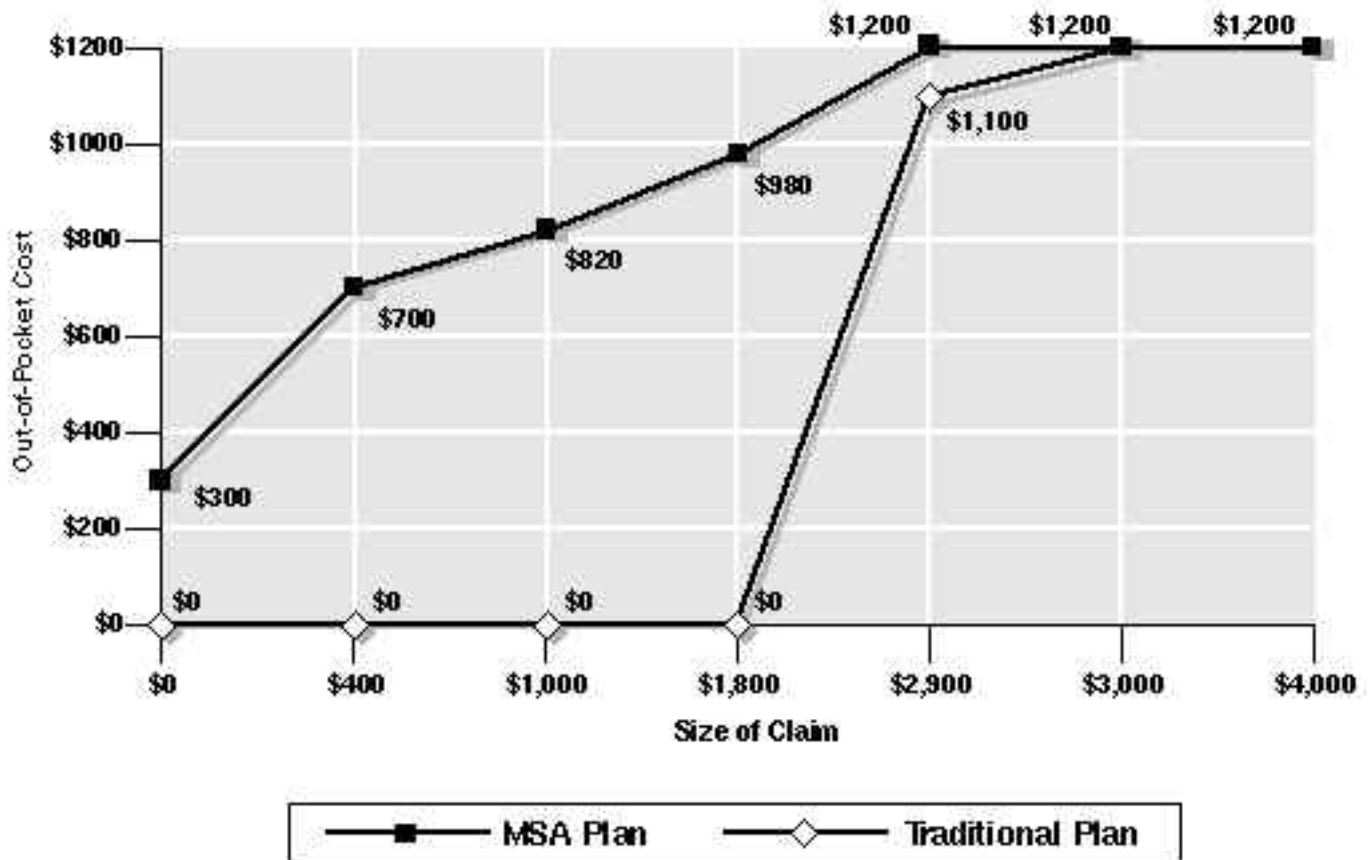
At the beginning of the next year, the employer makes another \$1,800 deposit into the employee's MSA. If the employer has a supplemental insurance plan to cover all health-care expenses above \$3,000, the employee's maximum out-of-pocket cost is \$1,200, even if he spends all his end-of-the-year MSA savings.

MSAs encourage saving for future expenses

But this example holds only if the employee started out the year without savings built up in the MSA. If the employee had built up balances from unspent money in previous years, a portion of those balances could be used to pay the \$1,200 OPC in this period.

In fact, most employees have funds remaining in their account at year end, and the sickest employees are no worse off than under their traditional plan.

Out-of-Pocket Costs to Employees Under a Traditional Plan and an MSA Plan



A survey of 17 firms using MSA's showed that over 70% of employees had funds remaining in their accounts at year end.⁷ The average amount remaining was \$600 for single individuals and around \$900 for families.

Thus, most employees who have had MSA plans for a few years would probably not have any OPC risk.⁸ This is different from traditional plans where most employees will have some OPC in any given year. Under traditional plans, each individual's account is "zeroed out" at the end of the year.

Traditional plans, also called indemnity plans, encourage excessive health-care spending. Once the low deductible is covered, the employee is paying little or nothing for additional care. Since the price paid by the consumer at that point becomes zero, the amount demanded increases rapidly.⁹

The MSA by contrast has a built-in incentive for employees to spend less: they get to use whatever remains at the end of the year. So, even though the MSA reduces the exposure of employees and families to health care spending, they are less likely to use the funds unwisely compared to traditional plans.

All employees might be better off with MSAs

Even the sickest of employees might be financially better off with MSA's.¹⁰ Suppose the firm deposits \$2,000 into an MSA, rather than \$1,800, but kept its \$3,000 deductible supplemental insurance plan. If an employee's health-care expenses were over \$3,000 in the traditional plan,

her OPC would be \$1,200. Under the MSA plan, she would pay the first \$2,000 in expenses with MSA money. Non-covered exposure is limited to only \$1,000 — less than the traditional plan — after which the catastrophic policy kicks in with 100% coverage. Thus, the sickest employees would be \$200 better off under an MSA plan than under the traditional plan.

Whether this would actually occur at any given firm is an actuarial question. Suppose, for example, that the above MSA plan had a \$3,000 deductible policy that cost \$3,300 (instead of the \$2,600 shown in the example). The total cost to the employer would then be \$5,100 (\$3,300 plus the original \$1,800 MSA deposit) which is \$100 more than their cost for the traditional policy. The employer could lower the plan cost to an even \$5,000 by only depositing \$1,700 in the MSA. In this situation, though, sicker employees would have a lower OPC under the traditional plan than under the MSA (that is, \$1,200 vs. \$1,300). "Adverse selection" might occur when the sick employees stay with the traditional plan and healthy employees choose the MSA. Thus, the key question is whether MSA's can have a total plan cost no greater than traditional insurance while keeping OPC's at or below the traditional health insurance plan.

Real world out-of-pocket exposure falls

What happens when firms adopt MSAs in the real world? Does the OPC for employees increase?

Evidence from 27 Ohio firms shows that it does not. OPC's of covered employees at these firms fell after MSA's were adopted. OPC's for single employees in these firms fell by \$317 under the MSA plans.¹¹ For family coverage, the OPC under the MSA averaged \$1,355 less than under the traditional plan. Several firms, including the United Mine Workers, kept OPC to zero under an MSA plan.¹²

Ongoing research on 400 firms nationally show the average maximum OPC under traditional family plans is around \$1,102 while OPC exposure for a family MSA plan is \$954.¹³

MSA's give employees strong incentives to use health-care services wisely since the money spent on health care reduces the balance in the MSA at the end of the year. MSA plans, accordingly, need fewer restrictions on health choices than managed care plans.

So, employees and their families benefit from greater freedom of choice among health-care providers and services.¹⁴ They are generally free to spend MSA balances on preventive care such as physical exams, inoculations, mammograms and other screenings, as well as items such as eye and dental care that are not covered by many traditional plans.

Not surprisingly, MSA's often increase the use of preventive care. At Golden Rule Insurance Company, a survey of employees using MSA's found 27% were using more health

services for the first time and 53% said they expect they will use additional services in the future.¹⁵

Portability

Portability is another advantage of MSA's. Funds remaining in the MSA are employee-owned.

They move with the employee if he changes jobs. This is different from recent federal legislation which prevents insurance companies from turning down new employees due to pre-existing conditions. Under an MSA plan, the employee can actually take the savings in the MSA and use it for health-care expenses if he or she changes jobs.

MSAs fund long-term care

MSA's are a source of financing for long-term care plans as well. Suppose, for example, a family obtains MSA coverage at age 25 from a firm and has this type of plan until age 65. If the employee had \$1,000 left in the MSA each year, and earned just 5% on the build up in the account, she would have \$120,800 at age 65. This would be enough to fund a generous long-term care plan to cover nursing home and home health-care expenses not paid by Medicare.¹⁶ In addition, the build-up could be used to supplement gaps in Medicare coverage and retirement income from Social Security and other pension payments.

MSA funds are tax free

Finally, MSA deposits for qualifying firms will be tax free to many employees in 1997. In 1996, MSA's became exempt from Ohio state income taxes. Congress passed legislation making MSA deposits exempt from federal income taxes for firms in a pilot program beginning in 1997.

If the firm does not qualify at the state or federal levels, the \$1,800 deposit will be treated as payroll income and subject to taxation. This can be partially offset by electing to make some of the MSA deposit a "flex" plan where health expenses are done on a pre-tax basis.

Given these advantages, it is no wonder that MSA plans are quite popular with most employees.

III. How Employers Benefit from MSAs

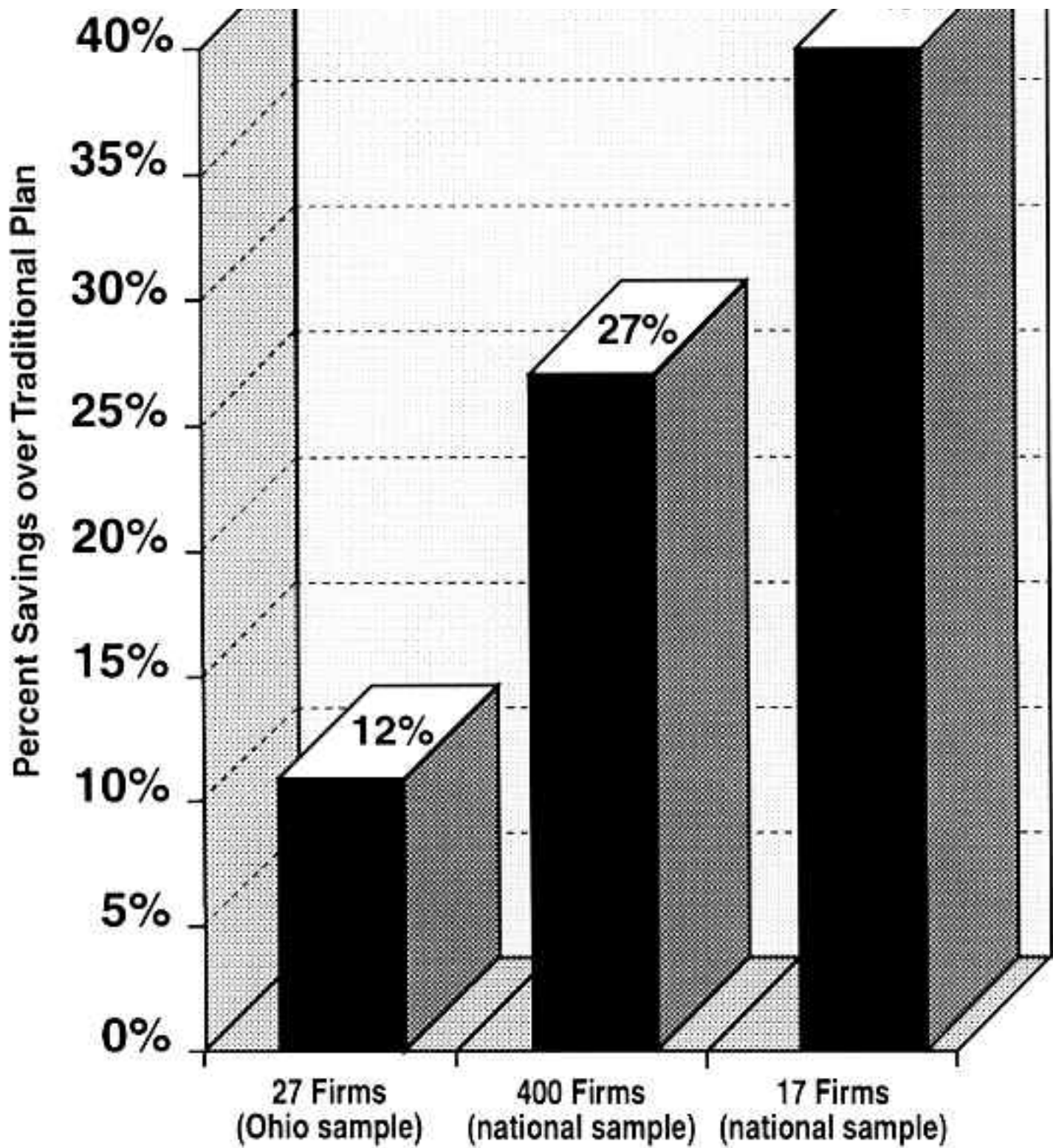
The primary benefit to employers from MSA plans is the potential for lowering health insurance costs.

How much could a firm save by switching to an MSA plan? Typically, savings range from 12% to 40%, depending on how the plan is structured and the initial health insurance costs faced by the firm (see box on page 11).

Figure 2

Average Health Care Cost Savings Experienced by Firms Adopting MSAs





Source: See box on page 11.

MSA plans cost less

MSA plans may cost less than traditional health insurance coverage for three reasons.

1. *Lower premium costs.* The MSA plan includes a high deductible policy of, say \$3,000, as opposed to much lower deductibles and co-pay amounts with standard health insurance packages. Obviously, since the insurance company (or employer in a self-funded plan) is responsible only for costs above \$3,000, and since roughly 80% of employees will have health expenses below that amount, this type of coverage is very inexpensive.¹⁷

2. *Employees become more cost conscious.* Employee behavior changes when they spend their own money on health care. In the MSA example in the previous section (on pages 4-7), an employee would have \$1,800 left in his MSA if he used no health care in any given year. By eliminating unnecessary spending and substituting lower-cost treatments, employees will maximize the funds left in their MSA's. Experience shows that health expenditures drop by an average of 15% to 20% in the first year of MSA plans.¹⁸

3. *Administrative costs are lower.* Since, the MSA is set up by the employer, the employee simply pays expenses and is reimbursed for it by the company (or its administrator). Costly insurance bureaucracies, and their forms, are bypassed. Estimates of the administrative savings from MSA Plans for a standard family policy are in the range of \$400 or more.¹⁹

For self-insured firms, the administrative savings would probably be lower because of economies of scale. Self-insuring the plan would bring benefits to both large and small employers because they are not bound by costly insurance mandates. The American Academy of Actuaries examined MSA Plans and found 2% administrative costs for MSA's versus 15% for more traditional plans.²⁰

MSA's and preventive care

MSA's may increase the use of preventative services. With the MSA plan, employees have the cash needed to use these services. Also, staying healthy means greater MSA savings for the employee. Thus, it becomes rational for employees to seek more preventive care. This could reduce costs for lost sick time and employer-provided life insurance.

Potential problems with MSAs

The biggest obstacle to implementing MSA plans is their tax treatment. Under existing federal law, employer expenses for health care are tax deductible for the company. The amount spent by the firm on health care is tax-free to the employee. Thus, if the employer spends \$5,000 on a traditional or HMO plan for employees, it deducts this amount from its taxable income for that year.

But, if the employer spends \$2,500 on a premium for a high deductible plan and deposits \$2,500 in an MSA, the MSA amount is considered income for tax purposes. Thus, the employee will have to pay income tax on the \$2,500 MSA deposit.

Savings from MSA's

- The American Academy of Actuaries concluded that an average MSA plan would cost between 2% and 11% less than established health plans. The 9% range was derived from different assumptions about the "cash" nature of the MSA.¹
- A study of 17 firms with MSA plans found single-coverage costs fell from \$2,319 for single employees with traditional coverage to \$2,133 under an MSA plan. Family MSA coverage averaged \$3,882 compared to \$6,536 under the traditional plan.²
- Another study examined MSA plan costs for 27 Ohio firms. When the costs were weighted per firm by the proportion of single and family coverage the average savings was around 12%.³
- An analysis of 400 firms in a nationwide study showed a decline in family coverage costs from \$4,824 to \$3,510 under an MSA plan. All evidence so far shows savings are considerably higher for family MSA plans.⁴
- Golden Rule Insurance Company offers both an MSA and a traditional health plan to its employees. The cost of the MSA plan was about 10% less than the traditional plan and remained unchanged in the first three years.⁵
- Morris County Hospital (Kansas) operated an MSA plan for 10 years until 1992 when new management took over. During the MSA plan period, employer health costs stabilized at less than 5% of payroll. Costs of employee sick time dropped to 1% of payroll. Most employees added the large annual savings to their retirement plans.⁶
- Dominion Resources implemented an MSA plan in 1989 after experiencing large increases in health costs. Using an MSA plan with high deductibles for employees, the firm was able to slow the rate of growth of health costs to around 1% per year and decrease total health benefit costs to about 3% of payroll.⁷
- *Forbes* Magazine set up an MSA plan in 1992. In the first year of the plan, the firm's health costs dropped by 23%, a total of about \$400,000. *Forbes* paid \$125,000 in bonuses for a net savings of about \$275,000.⁸

1. "Medical Savings Accounts: Cost Implications and Design Issues," *Public Policy Monograph No. 1*, American Academy of Actuaries. 2. S. Barchet, J. Anderson and L.S. Chapman, "Medical Savings Accounts: An Option to Reduce Health Care Costs and Increase Health Care Satisfaction," *ACA Journal* (Autumn 1995), pp. 34-47.

3. M.T. Bond, B.P. Hershizer, M.W. Hrivnak, "Reducing Employee Health Care Costs With Medical Savings Accounts," *Compensation and Benefits Review* (September/October 1996), pp.51-6.

4. Ongoing research by the author.

5. S. Barchet and R.J. Cihak, *Medical Savings Accounts: A Building Block for Sound Health Care* (Olympia, Wash.: Evergreen Freedom Foundation, Washington Medical Savings Account Project) 1995.

6. Ibid.

7. Ibid.

This is a disincentive for some firms to establish an MSA.

Still, despite this unfair tax treatment, MSA plans exist in over 2,000 firms in the U.S. That number would almost certainly rise if MSA's were placed on an equal tax footing with existing types of health insurance.

Governor Voinovich signed legislation in July, 1996 (H.B. 179) to make MSA deposits free from Ohio income tax beginning in 1997. Interest on the accounts will also be tax-free.

Recent federal legislation will give another 750,000 policy holders an opportunity to use MSA's without adverse tax consequences. The program applies only to firms with fewer than 50 employees. This policy, however, is only a pilot project and firms will qualify on a first come first serve basis.

For firms in the federal pilot program, the maximum amount firms could deposit annually in the MSA is equal to 65% of the high deductible amount for single coverage and 75% for family coverage. The accounts must be coupled with high-deductible coverage of not less than \$1,500 nor more than \$2,250 for single coverage and not less than \$3,000 nor more than \$4,500 for family coverage. The MSA is treated as a tax-exempt trust to be used for payment of medical expenses under IRS Section 213.

Disbursements from the trust are tax-free if used for these expenses. Disbursements can also be made for long-term care insurance premiums. Any other withdrawals are taxed as ordinary income, and are subject to a 15% penalty until age 59 1/2. Interest on the accounts is tax-free.

IV. Establishing an MSA

How can you set up a MSA plan at your firm?

Smaller firms will probably find complete self-funding, or self-funding with some combination of traditional insurance impractical.²¹ They may wish to buy an MSA from an insurance company. Since the passage of the federal pilot program last Summer, as many as 30 insurers will join existing companies and provide MSA plans for companies.²²

Putting together a proposal for an insurance company is a relatively easy task and does not differ substantially from the current process. Essentially, the insurance company will need information on you and your employees. They typically want the following information:

- **Total number of employees and whether they will be covered.**
- **The sex, age and date of birth for employees.**
- **Ages of spouses and children for family coverage.**
- **Employer zip code, city and state.**
- **Type of industry and SIC code if available.²³**

Firms can ensure they will get the lowest cost by requesting quotes from several providers.

MSA brokers may save time

Many insurance agents are not licensed with firms that sell MSA plans. Often, this leaves it up to the individual business to identify companies and generate quotes, a time-consuming task.

Fortunately, a few entrepreneurs have recognized the market for brokering MSA plans. For example, a firm located in Cleveland, Ohio, contracts with firms to find the lowest quotes from several MSA providers. Using a broker usually does not imply a commitment to use an MSA service, but it provides the time-strapped buyer with quick, reliable information.

Whether the firm prefers an insurance company plan or a partial or fully self-insured plan will depend first on its size. Most firms with fewer than 25 employees will be unable to self insure due to the difficulty of predicting expenses with a tiny pool. A firm that small could be bankrupted by a major employee claim if it were fully self-insured. Thus, most small employers would probably obtain an MSA plan through an insurance company.

Key Issues for Setting Up MSAs

- Find an insurance company or broker
- Size of MSA deposit
- Covered health-care services
- Deductible for supplemental insurance
- Maximum out-of-pocket exposure for covered employees and families
- Rules for pre-existing conditions

Company size also comes into play with regard to whether employees will have

additional options, such as a conventional plan or an HMO, in addition to the MSA. Again, the smaller firms (probably less than 50 employees) are not likely to find an insurance carrier willing to offer multiple plans to the company.

Setting up an MSA

Whether a company buys a MSA plan directly from an insurance company, works through a broker, or self-funds its plan, the CEO will need to consider several issues.

1. MSA funding levels

First, the company will have to determine (with an insurer or third party administrator's help) the best funding level for MSA deposits, deductibles and cost-sharing.

A continued increase in the deductible on a policy will yield less and less premium savings. Thus, the benefit from raising a deductible from \$0 to \$1,000 is much greater than the benefit from raising it from \$1,000 to \$2,000 or from \$2,000 to \$3,000. This is because many low-cost claims have relatively high administrative processing costs.

Employees may Prefer High Deductible Policies

Suppose one firm has a \$2,000 deductible policy and a \$1,000 MSA deposit. This creates a maximum out-of-pocket cost for the covered employee of \$1,000. Now, another firm produces the same maximum out-of-pocket result with a \$3,000 deductible policy and a \$2,000 MSA deposit.

Employees experiencing more severe illnesses will be indifferent between the plans because their out-of-pocket exposure is the same (\$1,000) in either case.

But healthier employees would prefer the second plan because they would have much more left in their MSAs. Most employees (and families) will probably spend less than \$2,000 on health-care expenses in any given year.

Most firms would usually have lower total MSA expenses with the \$2,000 deductible plan. The actual costs would have to be established in the MSA proposal. A firm that chooses to partially self-insure its MSA would have to determine how much overall expenditure on health insurance it is comfortable with and buy an insurance policy accordingly. A fully self-insured firm would have to rely on changes in overall utilization and lower administrative costs to fund the MSA deposits and produce overall firm savings.

On the other hand, a higher deductible combined with supplemental MSA funding is likely to be more popular with employees (see box on page 14).

2. Covered services

Another important element of any MSA proposal is to determine what services the catastrophic plan will cover. Since the MSA is an employer-funded, employee-owned account, it may be used for many types of health expenses that are not covered by the

high-deductible policy. In some plans, these expenses do not count towards satisfying the deductible amount. This could lead to dissatisfied employees (see box on this page).

The way to avoid such disappointed expectations is through employee education. Once covered expenses are properly explained to employees, the firm may wish to establish (or keep) a section 125 "flex" plan to allow them to spend pre-tax funds on anticipated health care needs that do not qualify for the MSA deductible.

(In the above example from the box, the employee could have separately deposited \$500 of his pay into a "flex" account for anticipated optical expenses. This deposit is spent on a pre-tax basis and is unrelated to the MSA plan, thus leaving the employee's OPC with the MSA at \$500.)

**Covered Health Care
Services Will Effect
Out-of-Pocket Costs**

Suppose, for example, that a firm has an MSA deposit of \$1,500 and a deductible amount of \$2,000. Thus, the employee is responsible for a maximum of \$500 out-of-pocket cost (OPC). Assume the employee uses \$500 from the MSA for optical expenses that are not counted towards deductible.

Later the same year, the employee becomes sick and has a total medical bill of \$3,000. The employee presumes that he will have an OPC of \$500 since he will use the remaining \$1,000 in his MSA and pay \$500. He assumes the remaining amount would be completely covered by the catastrophic plan.

But, in fact, the employee would have to pay \$1,000 out-of-pocket since the \$500 optical expense did not count toward the catastrophic deductible.

3. Out-of-pocket costs and deductible for supplemental insurance

Two other important issues will be the maximum amount of out-of-pocket expenses for employees and the size of the deductible on the supplemental insurance plan.

The size of the deductible on the supplemental plan will determine the size of the insurance premium. Obviously, a higher deductible translates into a lower premium.

On the other hand, the firm must also consider the out-of-pocket exposure for employees. In many cases, firms use the MSA plan to reduce the out-of-pocket exposure faced by most employees.

Examples of deductibles and out-of-pocket exposure used by existing firms with MSAs are provided in Appendix B.

4. Pre-existing conditions

Firms must also establish the rules for new enrollees with pre-existing conditions. This is important to ensure that expenses covered by MSA are the same as those covered by the high- deductible catastrophic insurance policy.

V. Other Issues

Provider networks

Employers may also consider other issues such as additional restrictions on health-care providers with regard to MSA funds.

Most employers with MSA plans let employees choose their own providers. Firms presume that fee reductions will occur because the employees will maximize remaining MSA

balances and because providers will discount services since they are paid immediately and do not have to deal with insurance company or employer reviews.

The freedom to choose providers is a major plus of the MSA. Many employees currently in managed care plans will find this option very desirable.

Other firms make arrangements with provider networks for guaranteed discounts to MSA policy holders. For example, the National Center for Policy Analysis has an MSA plan that allows 100% of covered expenses to count towards the MSA deductible if the employees use providers from a selected network. If they go outside of the network, NCPA will count 75% of the expense against the deductible.

Employee education

With the benefits of MSA's come greater responsibilities for employees. Employers should consider an employee education program if an MSA plan is adopted.

Americans have become largely insulated from the financial consequences of health-care decisions. In most cases, we pay few of our health care bills and therefore have little reason to be informed, prudent shoppers for medical services. If employers return this responsibility to employees, the employees will need support.

A firm might consider an effective education campaign in which the employer develops a comparison of the existing benefits plan and *how the new MSA plan will compare to current health benefits*. This process should be ongoing and should include information on program development, progress, advantages, offerings, and the relationship to the firm's benefit objectives. The firm should try to keep everyone informed about how well the new plan is working and whether its goals are being reached.

Information on *preventive services* should be included with MSA statements. Certain higher-risk employees might also be notified periodically of certain programs that might

have a positive impact on their health. This list can be extensive.

The firm may also set up an incentives for a *healthy lifestyles program*. Tangible benefits like small cash awards might be established to promote participation in health-promotion and illness-prevention programs. In return, the employees might sign an annual agreement regarding things like smoking, drinking, weight, diet, and exercise. Another element would be employer-

provided preventative medical examinations, immunizations, and diagnostic tests. This should be viewed as an investment by the firm in reduced health costs in the future.

Support services for MSA users would also be useful for involving the employee directly in the process and economics of health care decisions.

One item of great use would be providing a *list of usual, customary and reasonable charges* for specific health services so employees can ascertain whether a particular provider's fees are above or below the norm. This gives employees leverage to negotiate health costs down for their own (and the company's) financial benefit. Employers might even retain local doctors and nurses who, for a nominal fee, would advise employees on whether an ailment needs treatment or whether a second opinion is warranted.

Administration

The administration of the MSA can take many forms. The plan could be self-administered and the bookkeeping done in-house. Receipts and payments could be processed by a claims processor, a third party administrator or a bank. Whatever the approach, the administrator would have to account for deposits and withdrawals, pay for medical expenses, and store receipts.

This is different from current health-care claims processing. Most MSA's do not require routine and uniform monitoring of all MSA expenditures. This significantly lowers administrative costs. Only when total expenses exceed the catastrophic deductible amount would a review of previous expenses be necessary. The actual payment to the providers from the MSA could come from either the employee (who is quickly reimbursed from the MSA) or the employer, who could pay the provider directly upon receiving a bill.

MSA administration can be as low-level as ledger-entry for each account. An alternative and higher-level approach is to apply MSA adjustments to the firm's existing software. Administrative and accounting procedures can be easily adapted to allow for electronic billing and payments to providers.

Finally, the employer should undertake an annual review of the MSA plan and its administration. This will allow periodic revisions to compensate for changing economic or tax considerations. Employees should be invited to make suggestions for the plan's improvement.

Appendix A: MSA Q & A

Q & A for Employers

Q: What is a Medical Savings Account (MSA) Plan?

A: Most often, an MSA plan is a combination of an employer-funded, employee-owned account — the MSA — and a high-deductible health insurance policy that has 100% coverage.

For example, a family MSA plan might have a \$2,000 medical savings account combined with a \$3,000 deductible insurance policy. This means any health-care expenses above \$3,000 will be completely covered by the insurance policy. The maximum out-of-pocket cost for the

family will be \$1,000, the difference between the MSA and the deductible. Thus, if the family spends \$4,000 on health care, it will use all its MSA and pay \$1,000 out-of-pocket. If, on the other hand, the family spends \$1,000 on health care, the family still has \$1,000 left over in the account. This money belongs to the family and it still has not paid anything out-of-pocket.

Q. Why should I switch from my current coverage to an MSA Plan?

A. Several reasons.

First, an MSA plan may cost less than your current plan.

Second, a majority of employees will have leftover funds at the end of the year. This money is theirs to keep, spend, invest, save, or roll over into the following year's MSA.

Third, sicker employees will probably not pay more out of pocket than under your existing plan. This is obviously quite popular with employees (and you)!

Finally, employees have more freedom to choose doctors and health services under an MSA than they do under most current plans (especially managed care plans).

Q. How can a health plan that gives most of my employees money back cost less than my existing plan?

A. Once again, for several reasons.

First, with an MSA, most low-cost health spending is not processed through an insurance company and therefore involves lower administrative expenses. The employee brings in a receipt for the medical expense and is reimbursed (or requests payment to the provider).

Second, since employees are spending their own money with an employee-owned MSA, their health care utilization falls by around 15% to 20%. This means lower costs to you.

Finally, employees become very price-conscious with the health care they do use, and shop around for the lowest prices.

Q. If this is such a great idea, why hasn't my current insurer recommended it?

A. Probably for three reasons.

First many health insurance "experts" don't really know what MSA plans are because they are relatively new. They usually assume that MSA's are "flexible" benefit plans that allow pre-tax spending on health care with the unused amounts forfeited to your company.

Second, current insurers have little incentive to market MSA's. Your insurer's compensation is based on the size of your premium. Since you are buying a low-cost, high-deductible policy, your premium, and the insurance agent's commission, will probably be one third to two thirds lower than under traditional health insurance plans.

Finally, deposits to MSA plans are currently considered taxable income, so the employee does not actually receive the full amount of the MSA. Beginning this year, however, MSA deposits for some firms will be either totally or partially free from federal taxation. This is already the case for the Ohio income tax.

Q. Sounds like a good idea so far, but I don't want to be the first to try it. Is anybody else using MSA's?

A. Absolutely! Over 2,000 companies across the U.S. already use MSA plans. Research on these firms suggest MSA's lower employer costs, give most of the participating employees money back, do not cost sick employees any more than existing coverage, and increase choices.

Q. It still sounds too good to be true. What's the catch?

A. The catch is that your employees must accept the responsibility for becoming informed purchasers of health care. With an MSA, they have the financial incentive to do it.

Let's face it. All of us want the best health care that somebody else's money can buy. With an MSA, the amount spent by us is really our money and all the evidence suggests that we become much more prudent buyers of medical care under MSA's.

Q. OK. I'm convinced. How do I go about setting up a MSA Plan?

A. You can do it several different ways.

One way is to buy it directly through an insurer.

The second way is to fully self-fund an MSA, with your firm covering the expenses above the high deductible.

A third way is to self-fund the plan, but to protect yourself from high expenses by purchasing a stop-loss policy from an insurance company.

If your firm has fewer than 25 employees, you will probably prefer to buy an MSA plan from an insurance company. Small firms should not fully self-fund since a couple of expensive illnesses could bankrupt the company.

Q & A for Employees

Q: What is a Medical Savings Account (MSA) Plan?

A: Most often, an MSA plan is a combination of an employer-funded, employee-owned account — the MSA — and a high-deductible health insurance policy that has 100% coverage.

For example, a family MSA plan might have a \$2,000 medical savings account combined with a \$3,000 deductible insurance policy. This means any health-care expenses above \$3,000 will be completely covered by the insurance policy. The maximum out-of-pocket cost for the

family will be \$1,000, the different between the MSA and the deductible. Thus, if the family spends \$4,000 on health care, it will use all its MSA and pay \$1,000 out-of- pocket. If, on the other hand, the family spends \$1,000 on health care, the family still has \$1,000 left over in the account. This money belongs to the family and it still has not paid anything out-of- pocket.

Q. My employer is considering switching our health plan to an MSA. Why would I want one of these?

A. First, if you are healthy, or spend your MSA funds wisely, you will have money left over at the end of the year. This is yours to keep or roll over for future use.

Second, if you have a lot of health expenses you will probably pay no more out-of-pocket than with a traditional plan.

Third, you can generally pick you own doctor which you seldom can do in managed care plans.

Q. But I may change jobs soon. Won't I lose the money in my account?

A. No. The MSA is yours and is completely portable, even if you switch jobs.

Q. We currently have a provider network. I had to pick my doctor from that group, and I like her. Won't I have to go to someone else with the MSA?

A. No. Just tell your doctor that she can accept payment from either you or your employer.

If you pay the doctor, your employer (or the insurer) will reimburse you.

If your employer pays the doctor, the doctor need only send her bill to the employer.

Your doctor will probably like the fact that an insurance company is not telling her how to practice medicine. And she'll appreciate the prompt payment.

In exchange for this, tell her that you expect at least as good a price as she charges in the network. Most patients and doctors have horror stories about trying to get small insurance claims processed. The MSA eliminates that problem.

Q. My primary care doctor won't let me see a specialist for a problem I have. What happens with an MSA?

A. The only reason your primary care doctor won't let you see the specialist is because he is getting paid to discourage referrals. This is typical in managed care networks.

When you have an MSA, the primary care doctor has no incentive to discourage referrals. So, seeing a specialist should not be a problem if you feel you need one. Of course, you will have to pay for the specialist's services with money from your MSA.

With MSA coverage, you make the final decision on the services that are used.

Q. How do I know what a fair price is for seeing a doctor? Won't they take advantage of me?

A. You can get the best deal the same way you can when you buy anything else: ask questions and shop for the lowest price.

Any businessman, including your doctor, wants to charge you the highest price she can. When your doctor finds out she will be paid in cash from your MSA, she should be eager to discount her services to avoid the bureaucracy and red tape of going through an insurance company. Your employer may even help you by giving you a detailed schedule showing the customary charges for various health services.

The final decision over what services and doctors to use, however, is yours.

Q. My current plan does not cover eye-care and dental. Does the MSA?

A. The MSA is yours. You can spend the funds on any qualified medical expense (as defined by the IRS), including eye-care and dental.

But be careful. The high-deductible policy that accompanies your MSA may not count these expenses against the deductible. If this is the case, you might end up paying these costs out-of-pocket. The safest policy is to use any remaining MSA balances from previous years for non-covered expenses.

Q. Suppose my company puts \$2,000 in an MSA for me and my family, but we don't spend any money on health care that year. What happens to the \$2,000?

A. Starting in 1997, all or a portion of the MSA may be tax-free to you. If this is the case, you may leave the funds in the MSA tax free for future health expenses, to pay long-term care premiums, or for your retirement. Funds remaining in the account earn tax-free interest.

If you take funds out of the account for non-medical expenses before 59 1/2, you must pay federal income tax plus a 15% penalty. If the funds do not qualify for tax free status, they are considered wages and are taxed accordingly. Remaining balances are after-tax money and can be used for future health expense or taken as cash.

Appendix B: Examples of MSA Plans Currently in Use

Examples of Actual MSA Plan Structures and Costs

National National Dom- Golden

Type of Ohio Sample Sample inion Rule Insur-

MSA Plan Firms (1) (2) Resources ance Co.

Individual MSA Plan

Deductible \$1,500 \$2,000 \$1,500 \$2,000 \$2,000

MSA Account 857 1,199 1,073 1,500 1,000

Max. Out-of-Pocket 643 801 427 500 1,000

Insurance Premium 877 817 N/Av N/Av N/Av

Family MSA Plan

Deductible \$2,000 \$3,000 \$2,000 \$3,000 \$3,000

MSA Account 1,167 1,444 1,380 2,000 2,000

Max. Out-of-Pocket 833 1,556 620 1,000 1,000

Insurance Premium 2,081 2,013 N/Av 1,080 2,200

***Estimated Savings* 11.6% 10-15% 33-50% N/Av 38%**

***Source:* Data for 27 Ohio firms reported in M.T. Bond, B.P. Hershizer and M.W. Hrivnak, "Reducing Employee Health Expenses with Medical Savings Accounts," *Compensation and Benefits Review* (September/October 1996), tables 3,4; Data for national sample (1) of high deductible firms from M.T. Bond & B.P. Hershizer, research in progress; Data for national sample (2) of 17 firms with MSAs reported in Stephen Barchet, J. Anderson and L. Chapman, "Medical Savings Accounts: An Option to Reduce Health Care Costs and Increase Health Care Satisfaction," *ACA Journal* (Autumn 1995), pp. 34-47; Data for Dominion Resources and Golden Rule Insurance Company from S. Barchet and R. J. Cihak, *Medical Savings Accounts: A Building Block for Sound Health Care* (Olympia, Wash.: Evergreen Freedom Foundation, Washington Medical Savings Account Project, 1995), pp. 13-19.**

Appendix C: Preparing a Request for Providers

Whichever type of insurance plan a firm chooses, larger companies may have to prepare a request for proposals (RFP). RFP's ask potential providers, such as an insurance company, bank, or other third party MSA provider, for proposals for your company's health insurance. The RFP process creates a competitive bidding environment for health-care providers. RFPs must be designed carefully to ensure that bidders have all

the information they need.

Preliminary Steps to Medical Savings Accounts

- Talk to firms using MSAs
- Assess feasibility
- Perform historical analysis of benefits and use
- Collect employee data
- Prepare Request for Proposals (RFP)

While many companies may want to set up an MSA internally, most will probably want to use a third party provider such as an insurance company. This means they will have to prepare an RFP. The RFP will include all the information an insurance company would need to determine how much it would cost to set up and operate an MSA plan for the firm.

Before issuing an RFP, the following background and analysis is critical:

1. Talk to experienced firms. Firms considering MSA plans should first talk to employers with at least 2 years experience with these programs. They should also talk to employees of those firms. Next, they should talk to actuaries, brokers and insurers with this type of experience.

This kind of information gathering is crucial. While the basic MSA concept is sound, problems can arise if attention isn't give to the details. Conversations with others can help you identify these potentially problematic areas. For example, employer deposits to MSA's are generally made on a monthly basis. One employer quickly ran into the problem of employees having health expenses above the first month's deposit. The problem was solved by allowing them to "borrow" from their future monthly deposits. Such problems can be uncovered through discussions with other companies that use MSAs.

Employers should talk only to those with *actual* MSA experience. Only a small percentage of health insurance "experts" (brokers, agents, benefit consultants) have working knowledge of MSA plans. They will hesitate to recommend something they know little or nothing about.

In addition, brokers will hesitate to market and sell an insurance product that will reduce their commission by one third to two thirds.

2. Assess the plan's feasibility. Your company should set goals for employee

compensation and benefits. For example, at first, a 30-person firm with mostly single young male workers making \$15,000 per year is unlikely to find much interest in more traditional or HMO health insurance for two reasons. First, they are unlikely to become very sick, so the insurance is a "bad" deal for them. Second, they tend to be in low tax brackets, so there is little incentive to receive tax-free benefits.

But, explaining the MSA concept carefully can generate interest in the program. These employees will also likely have high remaining MSA balances at the end of each year. These balances can be used currently for other expenses or rolled over into savings-type accounts for future health care expenses. Thus, MSA's can be used as a way to extend benefits to a reluctant work force cost effectively.

3. Do an historical review. The health benefits program currently in place should be thoroughly reviewed by the firm, a consultant or a potential provider. This review should consider the program's design, total cost, participation levels and employee satisfaction. These results should then be analyzed to measure the company's total health-care costs, rates of increase, use of services, and sick leave expenses. Comparisons with similar firms in the area may also be useful. The company should also understand current health-care cost-management efforts, plan choices, employee attitudes, administrative burdens, plan responsiveness and measurable results. This information would be useful to carriers trying to assess the impact of switching to the high- deductible policy that accompanies an MSA.

4. Collect Employee Data. The firm or an outside company should also compile complete data on employee and family demographics, total plan cost experience, premium cost-sharing, average and maximum out of pocket expenses, total compensation, sick-day costs and non-participation. Then the firm should evaluate internal marketing options, the MSA laws in the firm's state, insurance obstacles to implementing the plan, availability of high-deductible plans and MSA administration.

5. Enrollment and benefit

coordination. Since the MSA will be a new plan option, the firm must establish rules for new enrollments, switching between alternate plans and the coordination of benefits. For example, many firms with MSA plans do not allow "double dipping." This might occur when a husband signs up for an MSA at his job and his wife places him on her insurance plan at her employment. This way he can draw MSA balances as income for the year or use the funds for unnecessary health expenses.

The firm will now be prepared to make a request to providers, which could include an insurance carrier or a third party administrator, for an MSA proposal.

About the Author

Dr. Michael T. Bond is a health care policy analyst for The Buckeye Institute for Public Policy Solutions. He is also an Associate Professor of Finance at Cleveland State University where he teaches health care finance. He has published over three dozen professional articles and papers in publications such as *Compensation and Benefits Review*, *Benefits Quarterly*, *HealthCare Financial Management*, the *Journal of Economics and Business*, and the *Quarterly Journal of Business and Economics*.

Resources

Additional information and resources regarding MSA Plans are available from the following sources:

- 1. Michael T. Bond, Ph.D., Finance Department, Cleveland State University, Cleveland, Ohio 44115, (216) 226-7990 or (216) 687-3728**
- 2. Stephen Barchet, Director, Washington Medical Savings Account Project, Evergreen Freedom Foundation, P.O. Box 552, Olympia, WA, 98507, (360) 956-3482.**
- 3. Greg Scandlen, Health Benefits Group, P.O. Box 806, Frederick, MD, 21705, (301) 682-8029**
- 4. Merrill Matthews, Executive Vice President, National Center for Policy Analysis, 12655 N. Central Expressway, Suite 720, Dallas, Texas, (214) 386-6272.**
- 5. David Lack, The Council For Affordable Health Insurance, 112 S. West Street, Alexandria, Va., 22314, (703) 836-6200.**
- 6. Sam Staley, Vice President for Research, The Buckeye Institute for Public Policy Solutions, 131 N. Ludlow St., Suite 317, Dayton, Ohio 45402, (937) 224-8352.**
- 7. The MSA Company,**
- 8. Greg Corrie, American Health Value, 6477 Fairview Avenue, Suite H, Boise, Idaho, 83704, (800) 914-3248**

End Notes

- 1. Estimate provided by National Center for Policy Analysis, Dallas, Texas, Fall, 1996**

- 2. These are companies served by only one provider, Golden Rule Insurance Company based in Indianapolis, Indiana. Numerous other companies will probably introduce MSA options with passage of recent state and federal legislation giving them favorable tax treatment. Even HMO's are beginning to add MSA products to their menu of services. See Paul Magnusson, "Your Doctor May Be In Again," *Newsweek*, December 30, 1996, p. 49 and Nancy Ann Jeffrey, "New Medical Plans for Small Businesses Carry Investment Options, but Also Risks," *Wall Street Journal* January 3, 1997, pp. C1, C14.**
- 3. M. Feldstein and Gruber, "A Major Risk Approach to Health Insurance Reform," *National Bureau of Economic Research (NBER) Working Paper No. 4852*, 1994.**
- 4. M. Eichner, M. McClellan and D. Wise, "Insurance or Self-Insurance? Variation, Persistence, and Individual Health Accounts," *NBER Working Paper No. 5640*, 1996.**
- 5. A. Enthoven, "The History and Principles of Managed Competition," *Health Affairs* 12 (1993), pp. 24-48.**
- 6. P. Somani, *Managed Choice: A New Proposal for Health Care Reform* (Columbus: Ohio Department of Health, Office of Government Affairs). n.d.**
- 7. S. Barchet, J. Anderson and L. Chapman, "Medical Savings Accounts: An Option to Reduce Health Care Costs and Increase Health Care Satisfaction," *ACA Journal* (Autumn 1995), pp. 34-47.**
- 8. The National Bureau of Economic Research documented that employees with high claims over a year or two are likely to revert to lower claims after that. In other words, they get sick and then they get well. Using a sample of 300,000 workers, NBER researchers found that, in any given year, around 10% of the employees accounted for 80% of health-care spending. Over 30 years, 55% of employees accounted for 80% of health spending. See Eichner, McClellan, and Wise, "Insurance or Self-Insurance."**
- 9. This is well documented in the academic literature. See C. Phelps, *Health Economics* (New York: Harper Collins) 1992.**
- 10. M.T. Bond, B.P. Hershizer and M.W. Hrivnak, "Reducing Employee Health Expenses with Medical Savings Accounts," *Compensation and Benefits Review* (September/October 1996), pp.51-6.**
- 11. Bond, Hershizer and Hrivnak, "Reducing Employee Health Expenses with Medical Savings Accounts."**
- 12. "Are Patients Satisfied with MSA's?" *Medical Economics*, October 9, 1995, pp. 120-1.**
- 13. Ongoing research by the author.**

14. There is growing concern about the effect of managed care on the quality of medical services. See, for example, "Sick People in Managed Care have Difficulty Getting Services and Treatment, New Survey Reports," *The Robert Wood Johnson Foundation*, June 28, 1995.
15. Independent survey of Golden Rule Employees by Luntz Research Company.
16. D. Manus, "Why Bother with Lon-Term Care Coverage?" *Business Health*, January, 1997, pp. 23-7.
17. An analysis of a national sample of about 400 firms by the author found average family premium costs of \$4,824 for traditional plans. MSA plans, in contrast, had average costs of \$4,510. This included \$2,360 average premium plus an MSA deposit averaging \$1,150.
18. M. Litow and S. Muller, *Medical Savings Accounts*, Milliman and Robertson, September 11, 1996.
19. Administrative costs for smaller firms may be as high as 40%. See, for example, U. Reinhardt, "Breaking American Health Policy Gridlock," *Health Affairs* (Summer 1991), p. 100.
20. "Medical Savings Accounts: Cost Implications and Design Issues," *Public Policy Monograph No. 1*, American Academy of Actuaries, p. 11.
21. Three types of plans could be established. A *fully insured plan* is what most people think of when they are "insured." an insurance company provides coverage for health care costs, and the company pays for the costs through premiums. At the other end of the spectrum is a *completely self-funded plan*. This occurs when a company decides to cover its employees' health care costs internally, without the use of an insurance company. A third alternative is a *self-funded plan with stop-loss insurance*. In this type of plan, the company pays claims up to a specific employee or company amount. If the claims go beyond these amounts, an insurance company becomes responsible for the loss.
22. Magnuson, "Your Doctor May Be In Agian."
23. The U.S. Department of Commerce assigns each industry a Standard Industrial Classification (SIC) code. SIC codes are available from the U.S. Department of commerce.