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HEARING ON HEALTH SAVINGS ACCOUNTS: THE EXPERIENCE SO FAR

SENATE FINANCE SUBCOMMITTEE ON HEALTH
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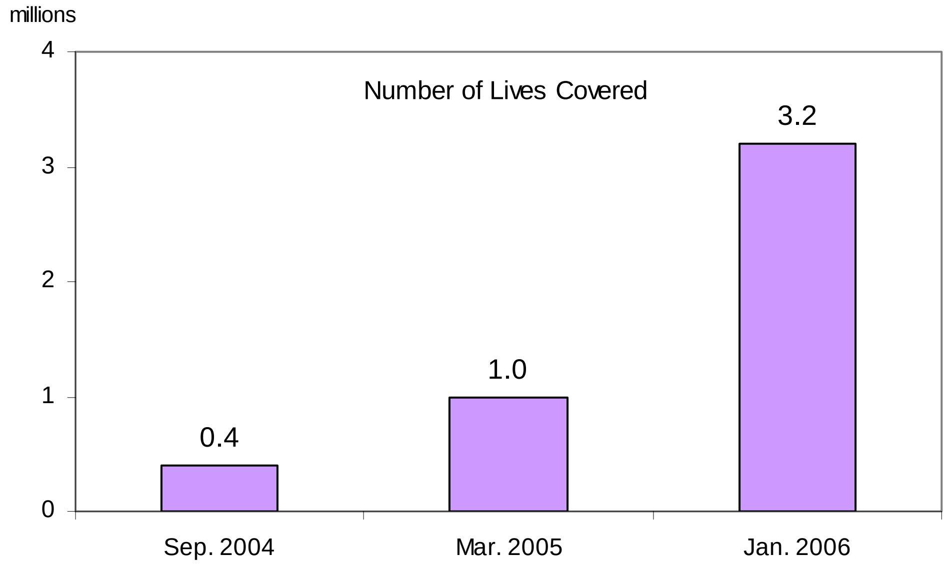
Chairman Hatch, Ranking Member Rockefeller, and distinguished Members of the Subcommittee, I appreciate the opportunity to discuss with you today the health savings accounts (HSAs) and the health care initiative included in the President's FY 2007 Budget. I will focus my remarks on both the problems in health care and how the President's proposals to expand HSAs help address these problems.

The Experience So Far with HSAs

The growth in high deductible health plans (HDHPs) since their inception has been dramatic. Enrollment in HSA-qualified HDHPs has grown to nearly 3.2 million individuals in January 2006, according to the latest estimates from America's Health Insurance Plans (AHIP). As shown in Chart 1, this is triple the number reported in 2005, which in turn was double the number reported in 2004, the first full year in which HSAs were available.

Chart 1: The number of HDHP/HSA-type plans has grown rapidly



Source: America's Health Insurance Plans, Center for Policy Research

Importantly, HSAs appear to have helped the uninsured and are being used by many lower income and older Americans. AHIP data also show roughly one-third of those who purchased HSA-eligible HDHPs in the non-group market were previously uninsured, and about 50 percent are age 40 or over. Other research shows that over 40 percent of those who purchased HSA-eligible plans in 2005 have incomes below $50,000. HSAs provide an additional option to individuals, which helps reduce the number of uninsured and helps lower income and older individuals.

The Broad Objectives of the President’s Health Care Initiative

The President’s initiative on health care is aimed at making health care more accessible, affordable, and portable, thus better enabling Americans to obtain health care and to retain their health care when they change employment.

Health insurance should be more accessible, regardless of where people work. Individuals and families should have access to a variety of health plans from which they can choose based on their individual needs and preferences.

Ideally, health insurance options at a reasonable cost would be available in all types of employment settings , not just for those who work at large firms that are capable of offering economical group health coverage to all of their employees. Employees of smaller firms, the self-employed, and those outside of the workforce should have similar choices at similar prices. One goal of the President's health care initiative is to remove the tax disincentive for individuals to purchase health care directly. It is simply unfair for individuals without access to health care through their employer to be denied the tax advantages given to those with access to employer-provided health insurance.

A key focus of the President's health care initiative is to put the consumer at the center of his or her own health care decisions. Empowering consumers is essential to improving value and affordability in American health care. When individuals are allowed to take greater control of their own health care decisions, we can expect those decisions to be better ones. Removing the tax disincentive against high deductible health plans (HDHPs) will help encourage the more efficient use of health care resources. Information about the range, price, and quality of health care options should also be readily available and easy to use. Purchasing decisions should be made by consumers, rather than surrogates, such as employers, insurers, or the government.

The President's health care initiative also recognizes that health insurance should be more affordable. The government has a responsibility to promote access to high quality and affordable health care for the poor. Our federal government also can provide financial assistance to low-income Americans and encourage the states and employers to help the chronically ill to obtain affordable health coverage.

Health insurance should be portable. Individuals should be able to take their health insurance with them when they change jobs, move, become self-employed, or leave the labor force. They should not have to worry about changing doctors, learning a new insurance company bureaucracy, having their premiums go up, or losing their insurance tax advantage when they move between employment opportunities.

The tax system should not impose a relative tax penalty on small employers that makes it difficult to recruit and retain workers.

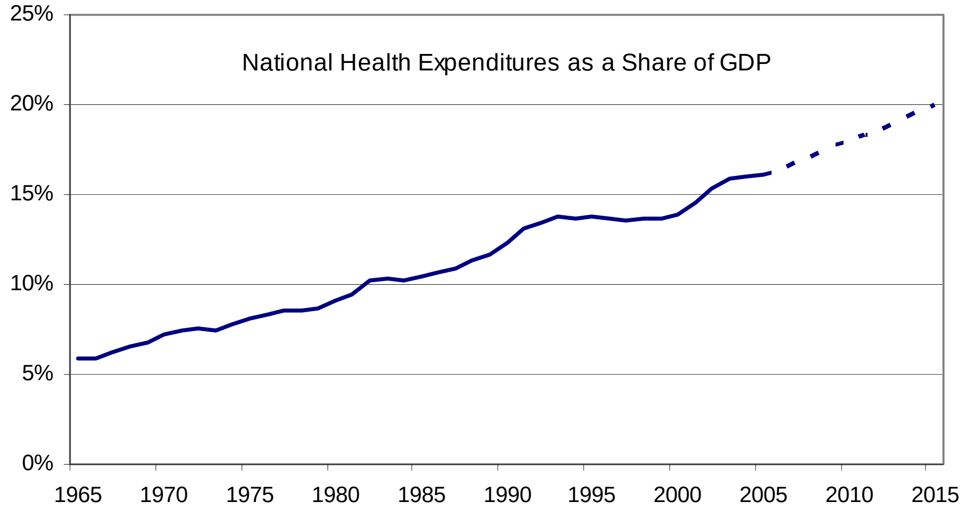
Americans enjoy the best health care facilities and medical professionals in the world, but Americans are concerned about the rising cost of health care, losing their health insurance if they change jobs, and a lack of information about price and quality. These concerns are based on real world observation and are valid. The President's health care initiative attempts to address the root problems that underlie these concerns.

Problems in Health Care

Rising Costs

Health care costs continue to rise rapidly. Growth in health care costs have been exceeding GDP growth by two percentage points annually since 1940. Chart 2 shows both actual and projected growth of national health expenditures as a percentage of GDP from 1965 through 2015. Most recently, growth of national health expenditures as a percentage of GDP rose from 13.8 percent in 2000 to 16 percent in 2004 and is expected to rise to nearly 20 percent by 2015. These rising costs impose a burden on the U.S. economy. Higher spending on public programs like Medicare and Medicaid strains state and Federal budgets. Higher insurance premiums pose a challenge for employers and burden workers with higher health costs and lower wage increases.

Chart 2: National health expenditures continue to rise as a share of GDP



Source: Department of Health and Human Services, Centers for Medicare and Medicaid Services.

The burden of rising health care costs is particularly problematic for small businesses, which often choose not to offer any health insurance to employees. According to the Kaiser Family Foundation's annual survey, nearly 100 percent of firms with 200 or more workers offer health insurance to their employees. Yet only 59 percent of firms with between 3 and 199 workers offer insurance to their employees, a decline of 9 percentage points from 2000.

The Uninsured

At the same time health care costs are rising, the number of uninsured also continues to grow. As health care costs grow faster than incomes, an increasing number of individuals are unable to purchase health insurance. Regardless of how the number of uninsured is measured, millions of Americans are currently uninsured.

Removal of Market Forces from Health Care Purchase Decisions

A substantial portion of rising health care costs is due to the effects of our insurance system itself. Health insurance gives people valuable protection and peace of mind that they will have help paying their medical bills should a major illness arise.

However, because third parties such as insurance companies, employers, and the government finance the vast majority of health care spending, most insured Americans do not know or feel the full cost of the health care services they consume.

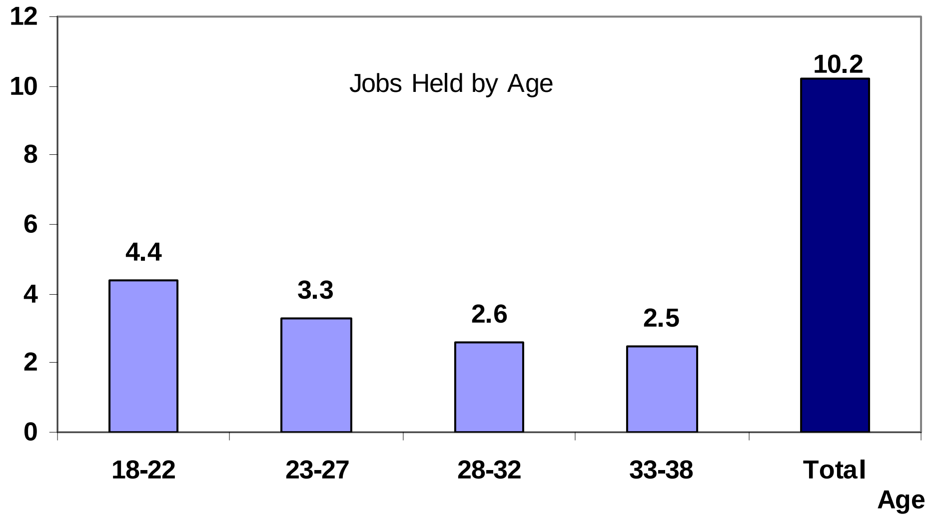
The direct expenditure for health care by an insured person may be only a small portion of his or her total health care costs. This is characteristic of low deductible and first dollar health insurance and the prevalence of this type of insurance is rooted in the tax treatment of health care generally. The tax code reduces the cost of health care when it is “pre-paid” or purchased in advance through employer-provided insurance. This has resulted in health care markets dominated by low deductibles, low coinsurance rates, and pre-paid coverage, all of which dull consumers’ incentives to be cost conscious and may lead to the over-consumption of medical care. This over-consumption is the rational response of consumers who do not have to directly pay the entire cost of the medical services they use. A change in the portion of the cost of medical services faced by the consumer so that he or she faces something closer to the true market cost of medical services – the marginal cost of health care – would encourage him or her to make better decisions and examine information on lower-cost alternative treatments. This may slow the steady increase in national health expenditures.

Health Insurance Is Not Directed Towards Today’s Dynamic Labor Markets

In today’s economy employees frequently change jobs. These changes are often for the better. The dynamism of U.S. labor markets provides important economic benefits by allowing our economy to adapt more quickly to changing economic circumstances. The fluidity and flexibility of our labor markets may generally lead to a better matching of workers to jobs and contribute to skill development and wage growth. Workers might change jobs in pursuit of better pay, to gain more work experience or broaden their skills, or possibly to attain more flexible work arrangements.

According to the Bureau of Labor Statistics' Job Openings and Labor Turnover Survey, in 2005, some 56.1 million employees were hired to fill jobs, while 53.1 million employees left their former positions, and this was a typical year for labor turnover. As shown in Chart 3, the

Chart 3: Job turnover is an important part of dynamic labor markets in the U.S.

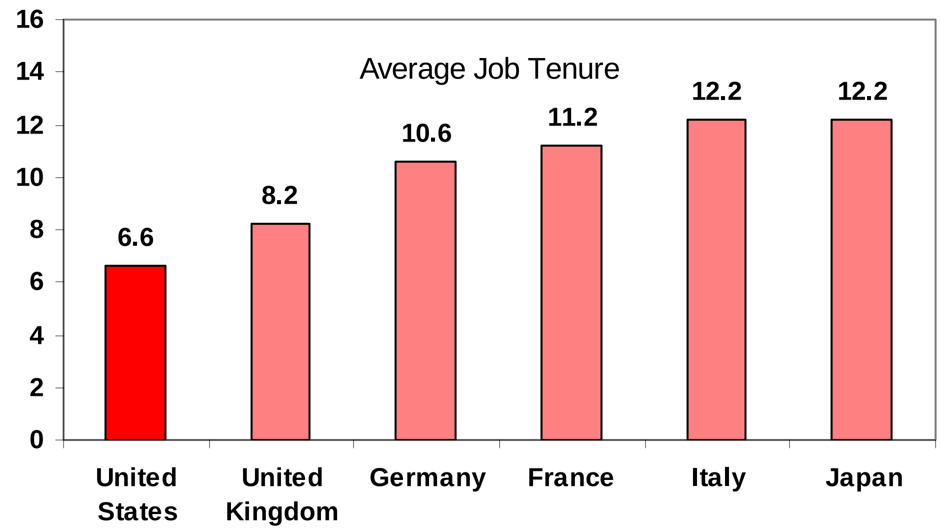


Source: Bureau of Labor Statistics, "Number of Jobs Held, Labor Market Activity, and Earnings Growth among Younger Baby Boomers: Recent Results from a Longitudinal Survey," August 25, 2004.

average American between the ages of 18 and 38 has held 10.2 jobs and the young are more apt to change jobs than those who are older. About two-thirds of lifetime wage growth occurs within the first 10 years of labor market experience. Seeking out and testing different jobs appears to be an important aspect of our labor markets and an important component of the economic progress for younger workers.

The high degree of job mobility and its role in building labor market experience and skills undoubtedly contributes to our economic vitality. As shown in Chart 4, Americans tend to change jobs much more frequently than workers in other major industrialized nations, in some cases nearly twice as often. The better matching of workers to jobs associated with the high degree of labor force dynamics contributes to economic growth and living standards by increasing the productivity of labor.

Chart 4: Labor markets in the U.S. are characterized by greater flexibility than our major trading partners



Source: International Labor Organization, "World Employment Report 2004-05," December 2004.

Tying employees' health insurance to their workplace, however, is an impediment to a dynamic labor market. Approximately 73 percent of insured Americans obtain their insurance in whole or in part through their employers. Employer-based health insurance is usually not portable when employees change jobs or stop working. People changing jobs usually must change insurance policies to receive any health benefits from their new employer. Lack of portability results in "job lock" – if anyone in the family is in poor or questionable health status, workers become hesitant to leave their jobs to work for an employer who does not offer insurance, work for themselves, or retire. Job lock has the effect of reducing the fluidity and flexibility of our labor markets and is a drag on economic growth.

How Does The President's Health Care Initiative Address the Problems

Major Parts of the Initiative

With the appropriate reforms, the U.S. health care system can become more efficient at supplying cost-effective health care to consumers while continuing to lead in innovation and the development of cutting edge medicines.

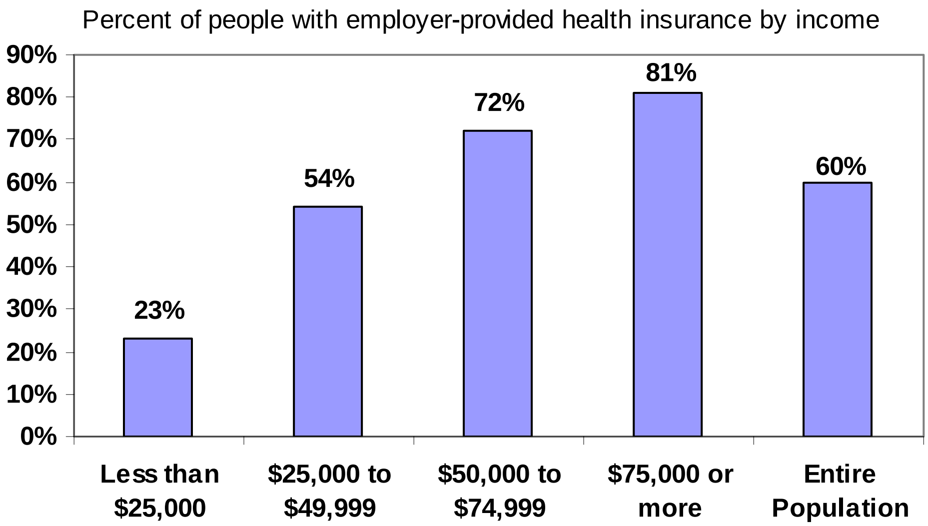
The President's initiative would address the rising costs of health care spending through a series of initiatives designed to encourage more efficient use of health care resources by improving consumer incentives. At the core of this initiative is a set of tax proposals that remove the tax disincentives to purchase high deductible health plans (HDHPs) and purchase health care directly. These changes put the health care consumer more in control of his or her health care and could result in lower health expenditures and lower health insurance premiums.

Currently, health insurance purchased through an employer is subject to neither income nor payroll taxes. While an individual purchasing health care on his or her own might pay one dollar for a dollar's worth of health care, an individual who obtains health care through an employer-provided insurance plan pays considerably less. Consider, for example, a taxpayer who is in the 15 percent income tax bracket and also pays 15.3 percent in Social Security and Medicare taxes (including both the employee and employer shares). For the last dollar of wages received, this taxpayer would pay 30.3 cents in income and payroll taxes. Thus, for every dollar of wages received, this individual could purchase only 69.7 cents of most consumption items. In the case of health care financed through an employer, however, the individual can purchase a dollar of "pre-paid" health care through a health insurance policy for every dollar of wages received. Thus, the current tax system builds in a large tax subsidy for "pre-paid" health care in the form of employer-provided health insurance.

Smaller firms are comparatively disadvantaged by this system. As already mentioned, many small businesses cannot afford to offer insurance and their workers are often among the uninsured. But those who work for larger companies currently receive a significant tax advantage: they pay neither income taxes nor payroll taxes on their health insurance premiums. In contrast, those who purchase insurance directly – perhaps because they work for a small business that does not offer insurance – pay for insurance after paying income and payroll taxes.

The President's proposals would also reduce the possibility of job lock. HSAs are owned by individuals regardless of their employer. When workers change jobs, they take their HSAs with them, reducing the possibility of job lock. An individual could seek the best job possible regardless of whether the employer offers insurance coverage, or become self-employed and still have the opportunity to take advantage of the tax benefits provided by the President's proposals.

Chart 5: Low-income families often aren't covered by employer-provided health insurance.



Source: U.S. Department of Commerce, Bureau of the Census, Current Population Survey, March 2005

Moreover, as shown in Chart 5, lower income individuals are less likely to be covered by employer-provided insurance. Policies that make health insurance more accessible and affordable to all Americans by extending the tax advantages enjoyed by those receiving their insurance through their employers would be particularly helpful to these lower income individuals.

There are several parts to the proposal. First, all taxpayers could either deduct or exclude for income tax purposes health insurance premiums for high deductible health care plans (HDHP). In addition, individuals would receive a refundable income tax credit for payroll taxes paid on those premiums.

These two provisions effectively place insurance purchased directly by individuals on an equal footing with insurance purchased through an employer, provided the insurance purchased is an HDHP.

Next, all taxpayers that have an HDHP could deduct a higher level of out-of-pocket expenses for income tax purposes through the use of an HSA than under current law. Also, taxpayers could claim a tax credit for payroll taxes paid on out-of-pocket expenses through the use of that same HSA. The amount of out-of-pocket expenses that could be deducted would be equal to the amount of out-of pocket exposure allowed for a qualifying HDHP. These two proposals have the effect of placing out-of-pocket expenses for those with an HDHP on an equal footing with "pre-paid" health insurance.

Once a taxpayer decides to purchase an HDHP, he or she would effectively receive the same tax advantages on his or her health care expenditures -- insurance and out-of-pocket -- as those who finance all their health care through an employer-provided health plan. The initiative eliminates the current tax disincentive to purchase of HDHPs and removes the tax bias that makes health care cheaper when purchased through pre-paid insurance, more attractive, than out-of-pocket payments.

The third major piece of the initiative is a refundable health insurance tax credit (HITC) for lower-income individuals for the purchase of an HDHP. The credit would be refundable and cover up to 90 percent of the cost of the health insurance up to $1,000 for singles and up to $3,000 for families. This provision would make health care more affordable to lower-income individuals and encourage those currently uncovered to obtain health insurance.

Giving Consumers a Greater Stake in Health Care Decisions – Slowing the Growth in Health Care Costs

An HDHP gives consumers a greater stake in their health care decisions.

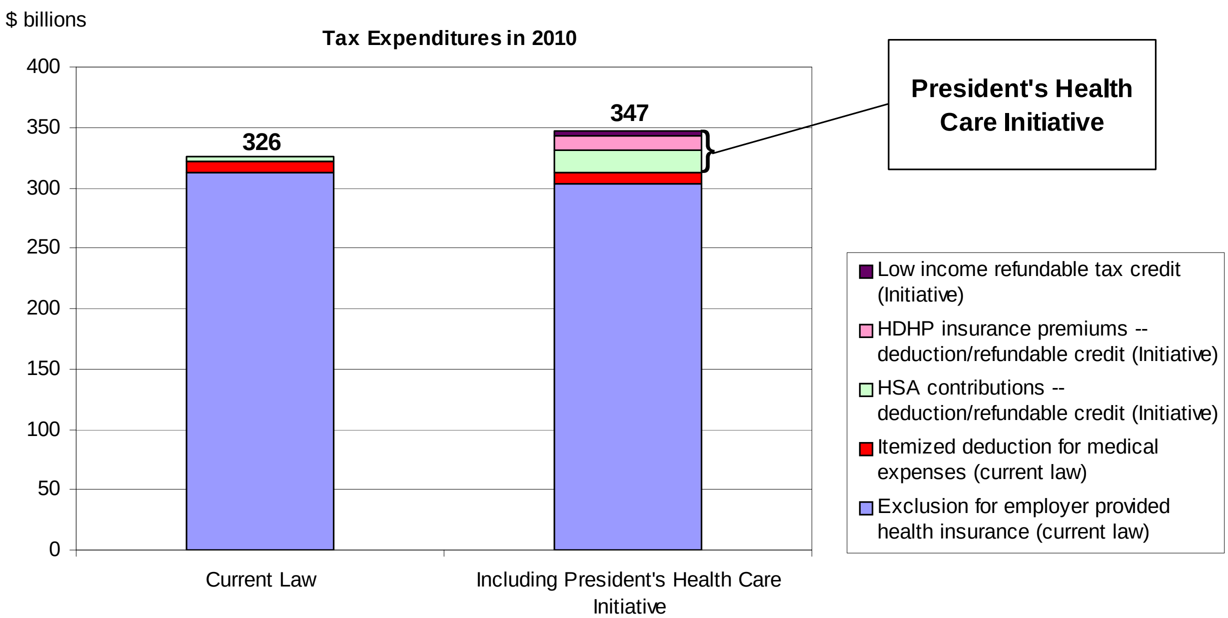
There is considerable evidence that the consumption of health care is sensitive to prices and that removing the tax bias for first dollar coverage can have an effect on health care spending. Currently, an insured individual with an HDHP has responsibility for payment of at least the first $1,050 (with no more than a total $5,250 out-of-pocket exposure) of medical costs. The President's initiative, by increasing the HSA contribution limits to the out-of-pocket maximum ($10,500 for families) ensures that individuals purchasing health care via an HSA-eligible HDHP receive the same tax treatment as employer-provided coverage up to the limits of their potential out-of-pocket costs. . It has been estimated that individuals who switch from traditional first dollar insurance to HSAs with spending below the out-of-pocket maximum would reduce their spending by 21 percent. Overall, it has been estimated health care spending would fall by 1.2 percent because of the greater exposure people who switch from traditional health insurance to HSAs would face under the President's initiative

Health care spending also has the potential to grow more slowly over time as individuals become more cost-conscious and bear a larger share of the financial responsibility for their health care decisions. In health care markets where market forces are prevalent, health care costs have grown more slowly or, in some cases, even decreased. Markets such as the laser eye surgery market and the in vitro fertilization markets, where there is significant competition, have experienced price decreases. To put this into perspective, if greater cost consciousness through the President's initiative were able to lower the growth in health care costs by just 0.5 percent, the effects on health care spending over time could be dramatic. In just ten years, this decline in the growth rate would lower health care spending by 5 percent and would be an entire percent point lower as a fraction of GDP in 2015 (e.g., $162 billion).

What is the Cost of the President's Initiative?

Chart 6 shows the health care tax expenditures under current law and under the President's health care initiatives for fiscal year 2010 for both income and payroll taxes. As can be seen, the current tax subsidy for the employee exclusion for employer-provided health insurance constitutes the major portion of the health care tax expenditure, either currently or under the President's initiative. As a result of the President's health care initiative, total health tax expenditures would increase by about $21 billion or somewhat over 6 percent in 2010.

Chart 6: President's Health Care Initiative complements already existing health care tax expenditures



Note: The estimates include the tax expenditure related to both income and payroll taxes. The estimates also include the effects on outlays.

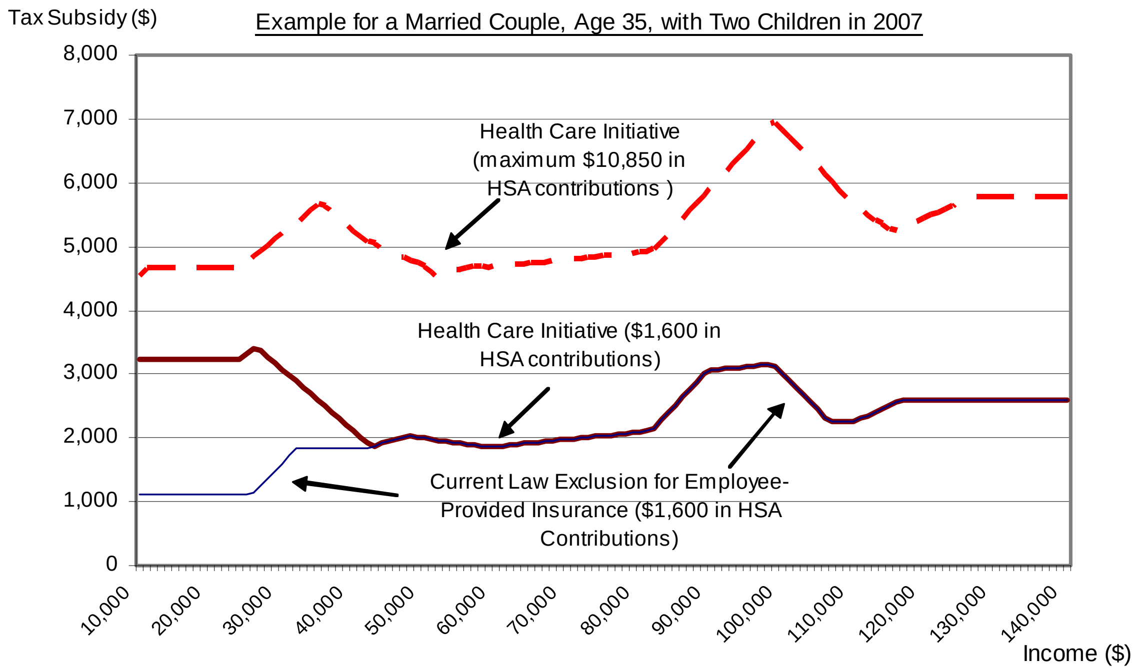
Source: U.S. Department of the Treasury, Office of Tax Analysis.

Where Does the Presidents Health Care Initiative Take Us?

The President's health care initiative levels the playing field between employer-provided insurance and HDHP insurance purchased directly by an individual and also levels the playing field between out-of pocket expenditures and insurance premiums for those with an HDHP. A key benefit of the initiative is that it reduces the tax bias towards lower deductible and first dollar health insurance. As discussed above, first dollar insurance dulls the incentives for consumers to shop carefully for cost-effective health care. Placing the consumer at the center of health care decisions helps slow the growth in health care spending. Greater reliance on health insurance purchased directly by individuals, and on HSAs generally, will also increase portability and reduce the harmful effects of job lock.

The initiative also makes HSAs more progressive. Lower income Americans receive a larger tax subsidy through the refundable health insurance tax credit targeted to low income individuals and through the set of refundable tax credits for Social Security and Medicare taxes. The latter set of credits is reduced once an individual reaches the taxable wage cap for Social Security taxes. Chart 7 compares the tax subsidy from the health care tax provisions under current law to those received under the President's health care initiative for a couple at age 35 with two children. When the family's income exceeds roughly $45,000, the President's health care initiative provides the same tax subsidy for a family purchasing health care directly as it does for a family purchasing their insurance through their employer under current law. Also, the tax subsidy under the President's health care initiative is higher for lower income families than under current law. For those with the lowest incomes, the President's initiative would provide a subsidy for more than half of a family's insurance premiums.

Chart 7: Health Care Tax Subsidy Under Current Law and the President's Health Care Initiative



Note: The family is assumed to pay a health insurance premium of $6,200 and make an HSA contribution of $1,600, except as noted above. The maximum HSA contribution under the proposal is $10,850 (in 2007). The taxpayer is assumed to receive all income from w ages.

Source: U.S. Department of the Treasury, Office of Tax Analysis.

As shown in Chart 7, there is a significant tax benefit from contributing the maximum amount to an HSA under the President's initiative, with the tax subsidy initially increasing with income because of the graduated income tax rates. The tax subsidy declines once the taxable wage cap for Social Security taxes is reached. Thus, there is a limit on the tax benefit from the payroll tax credit for higher-income earners.

The maximum tax benefit provided by the HITC targeted to lower income individuals is available for single individuals with incomes below $15,000 and is completely phased out when a single individual's income reaches $25,000. For families, the maximum tax benefit provided by the HITC is available for incomes below $25,000 and completely phased out when a family's income reaches $60,000.

The President's initiative makes HSAs significantly more attractive to both the uninsured and to lower-income individuals. The Treasury Department estimates that the President's initiative would increase the number of HSAs by some 50 percent by 2010. This initiative would also help control the growth in national health expenditures by encouraging the use of HSAs and HDHPs.

Conclusion

It is also important to consider these tax provisions as part of the President's broader initiative. The broader initiative outlined by the President includes: new national Portable HSA insurance plans; a proposal to permit the purchase of health insurance policies across state lines; a proposal to allow associations of small businesses to band together to purchase health insurance; medical liability reform; and a series of health information technology actions.

I thank you for the opportunity to testify before the Subcommittee and look forward to your questions.

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