The Economic Case for Health Care Reform

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Statement before the Committee on the Budget of the U.S. House of Representatives
June 19, 2009

Chairman Spratt, Ranking Member Ryan, members of the Committee, it is an honor to be with you today to discuss the economic impact of health care reform. The President has identified comprehensive health care reform as a top priority. In my testimony today, I will discuss the impact of successful reform on American families, businesses, the government budget, and the overall economy. Two weeks ago, the Council of Economic Advisers issued a report on this topic. With your permission, I would like to submit a copy of our report for the record. It contains the detailed analysis and citations to the relevant literature that form the basis for my comments today.

The key finding of the report is that doing health care reform well will have tremendous benefits for the economy. If we can genuinely restrain the growth rate of health care costs significantly, while assuring quality, affordable health care for all Americans, living standards would rise, the budget deficit would be much smaller, unemployment could fall, and labor markets would likely function more efficiently. Because the economic benefits that we identify depend crucially on not just doing health care reform, but doing it well, we hope that our report will help strengthen the resolve of policymakers to undertake the serious changes that are necessary.

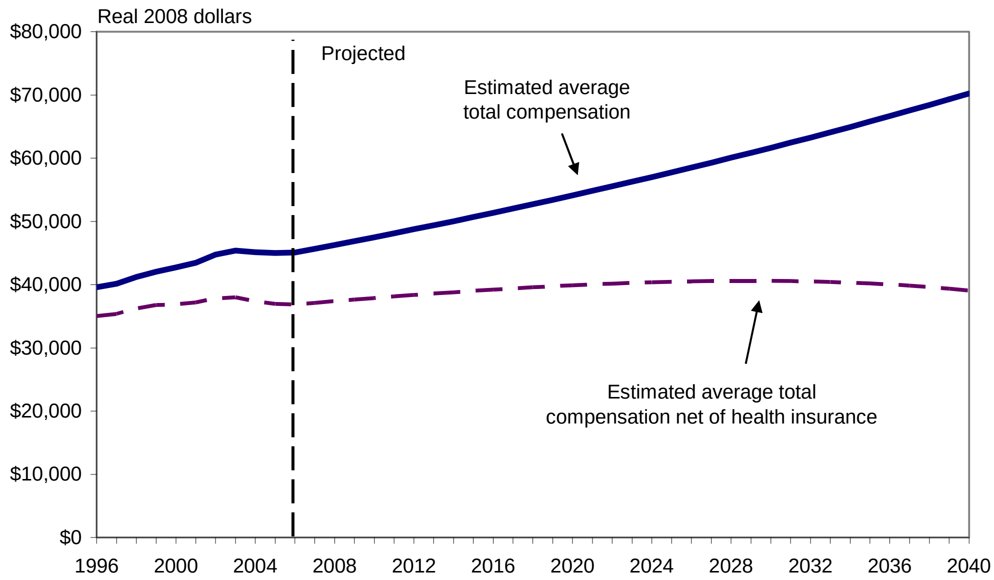
Trends in the Absence of Reform

The report has four key sections. The first discusses some of the key projections of what is likely to happen in the health care sector without successful reform. If you want—it shows the costs of doing nothing.

One fact that is well known is that health care expenditures in the United States are currently about 18 percent of GDP, by far the highest of any country. These expenditures are projected to rise sharply. By 2040, health expenditures could be roughly one-third of total output in the U.S. economy.

For households, rising health care expenditures will likely show up in rising insurance premiums. Even if employers continue to pay the lion's share of premiums, both economic theory and empirical evidence suggest that this trend will show up in stagnating take-home wages. This figure (Figure 3 in the report) shows our projection of total compensation and compensation less insurance costs, both in inflation-adjusted dollars. We project that without reform, the non-insurance part of compensation will grow very slowly, and likely fall eventually, as premiums rise sharply over time.

Figure 3: Projected Annual Total Compensation and Health Insurance Premiums



Source: CEA calculations.

Rapidly rising health care costs also mean that total government spending on Medicare and Medicaid (including state spending) will rise sharply over time. Our projections suggest that these expenditures, which are currently about 6 percent of GDP, will rise to 15 percent of GDP by 2040. A crucial fact is that only about one-quarter of the total rise in government health expenditures is due to demographic changes. The other three-quarters is due to the fact that health care spending per enrollee is rising much more rapidly than GDP. In the absence of tremendous increases in taxes or reductions in other types of government spending, this trend implies a devastating, and frankly unsustainable, rise in the Federal budget deficit.

Another trend that is well known, but too crucial to be ignored, is the rise in the number of Americans without health insurance. Currently 46 million people in the United States are uninsured. In the absence of reform, this number is projected to rise to about 72 million by 2040.

Needed Reforms

A second key part of our study looks at the inefficiencies in our current system and the market failures leading to our lack of insurance. It is important to diagnose the problem before one can sensibly discuss solutions. This part of the report also discusses the key goals the President has laid out for reform. One is to slow the growth rate of health care costs significantly, while maintaining quality and choice of doctors and plans. Another is to expand health insurance coverage to all Americans.

Since reform plans are very much in the process of being developed cooperatively with the Congress, our report does not describe in detail the reforms that would enable us to achieve these goals. But, to make the analysis credible, we give a sense of the kind of changes that might be implemented. For example, we discuss changes in payments systems, investments in health information technology, and research on what works and what doesn't that could help to slow the growth rate of health care costs over time. The President, in his speech last Monday to the American Medical Association, made some specific suggestions for reform along these lines. He also said that he was open to changes that would give the recommendations of the Medicare Payment Advisory Commission greater chance of adoption and implementation.

The CEA report also surveys the evidence, much of it from international comparisons and comparisons across different parts of the United States, that there is substantial inefficiency in the current system. The finding of this survey is that up to 30 percent of health expenditures in the United States (which is equivalent to about 5 percent of GDP) could be cut without affecting health care quality or outcomes. This is important in making the case that slowing the growth rate of costs by improving efficiency is possible. For example, our estimates suggest that we could slow cost growth by 1.5 percentage points per year for almost a quarter of a century before we have exhausted the existing inefficiency.

However, I do not want to sugarcoat the situation. Slowing cost growth by 1.5 percentage points per year may sound small, but it is likely to be very challenging. It will take an incredible degree of resolve and cooperation among policymakers, consumers, and providers to bring this about. It will require policymakers to take actions that will likely step on toes now, but whose cost-slowing benefits may well not be felt until five or even ten years into the future. But, what our study shows is that slowing health care cost growth significantly should be possible.

Economic Impact of Slowing Cost Growth

More fundamentally, what our study shows is that the economic benefits of taking actions to slow cost growth will be enormous. This is, in fact, the conclusion of the third key part of our study, which looks at the economic effects of successful reform. In our study, we consider the effects of cost containment and coverage expansion separately. But obviously, the two are related. Expanding coverage is likely to make certain types of cost containment easier to achieve. For example, widespread access to primary care is likely to increase the emphasis on disease prevention and wellness. Smoking cessation and weight management are two preventative measures that could reduce cost growth over time, while improving health and quality of life.

In our analysis of cost containment, we focus on slowing the growth rate of costs. This is the so-called "curve-bending" that can last for decades. Slowing the growth rate of costs is quite separate from actions that we might take immediately to cut the level of government medical spending, such as the more than $300 billion of Medicare and Medicaid savings proposed in our budget and the roughly $313 billion of additional savings the Administration proposed last Saturday. These immediate cuts are unquestionably important for paying for the expansion of coverage and health care reforms in the next decade. But, for thinking about the changes that will save us from the unsustainable long-run trends I discussed earlier, slowing cost growth year after year is essential, and what we focus on in our study.

We consider varying degrees of cost containment. In particular, we look at the effects of slowing the annual growth rate of health care costs by 1.5, 1.0, and 0.5 percentage points. To be conservative, we assume that it takes a few years for genuine curve-bending to kick in.

The fundamental thing that slowing cost growth does is free up resources. If we restrain costs by eliminating waste and inefficiency, we can have the same real amount of health care with resources left over to produce other things that we value. This causes standards of living to rise.

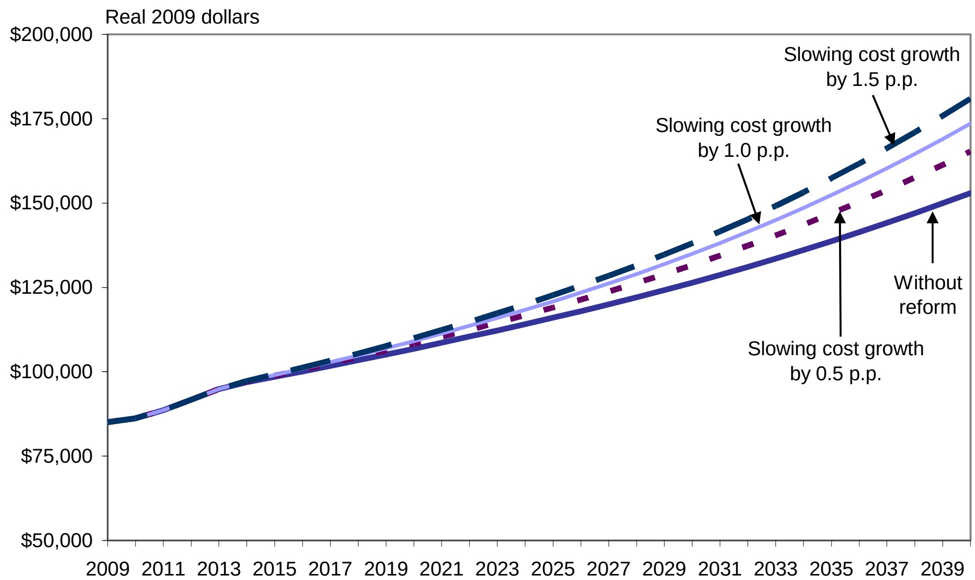
We analyze the effects of this freeing up of resources in a standard growth accounting framework. Now, nothing says how we would use those freed up resources. We may spend some of them on increasing the quantity of health care by expanding coverage. We also might choose to use some of the freed up resources to improve the quality of our health care. But, the crucial finding of our analysis is that we can have a lot more of the things we value as a country if we slow the growth rate of health care costs.

We then expand our framework to analyze what slowing cost growth would do for the deficit and capital formation (or investment). Because the government is a major provider of health care, slowing the growth rate of health care costs would lower the deficit and thus raise public saving. And, efficiency gains that raise income would lead to some additional private saving. All of this increased saving would tend to lower interest rates and encourage investment. This extra investment increases output even more.

Our estimates suggest that the combined impact of greater efficiency in health care and greater investment is very large. If we can slow cost growth by 1.5 percentage points, we estimate that correctly measured real output in 2020 would be about 2½ percent higher than it otherwise would have been. By 2030, it would be nearly 8 percent higher. If we only manage to slow growth by 1 percentage point, real output would be about 1½ percent higher in 2020 and 5½ percent higher in 2030. These results show very clearly that the more we can slow cost growth, the more rapidly living standards will improve.

To make these numbers more concrete, we translate them into the effects on the income of a typical family of four (in constant dollars). These effects are shown in this figure (Figure 15 from the report). The bottom line shows the projected path of real family income without reform. The higher paths show family income under different degrees of cost containment. Our numbers suggest that if we slow cost growth by 1.5 percentage points per year, family income would be about $2,600 higher in 2020 than it otherwise would have been. By 2030, it would be nearly $10,000 higher.

Figure 15: Estimated Family Income with and without Health Care Reform

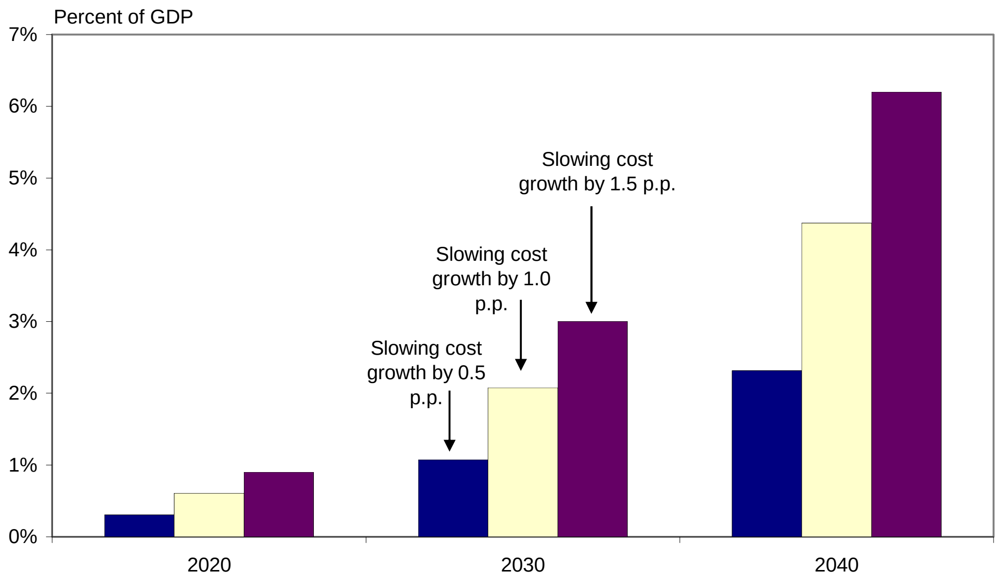


Source: CEA calculations.

I also want to show you what our analysis implies about the effect of health care cost containment on the Federal budget deficit. I need to be very clear that our estimates are not official budget projections, which would be based on detailed projections of spending and revenues. Ours are more a back-of-the-envelope calculation. And, they do not include the costs of coverage expansion, because most of those costs will be covered by the spending cuts and revenue increases that are currently under discussion. Our numbers show the effect of slowing cost growth over the long term.

We find that the effects on the deficit are very large. This figure (Figure 14 from the report) shows the deficit reduction in key years. If we can slow cost growth by 1.5 percentage points per year, we estimate the deficit in 2030 will be 3 percent of GDP smaller than it otherwise would have been. In 2040, it would be 6 percent of GDP smaller. The numbers illustrate the crucial truth that serious health care cost growth containment is the number one thing we can do to ensure our long-term fiscal health. Health reform is central to long-run fiscal stability.

Figure 14: Reduction in Federal Budget Deficit Due to Health Care Reform

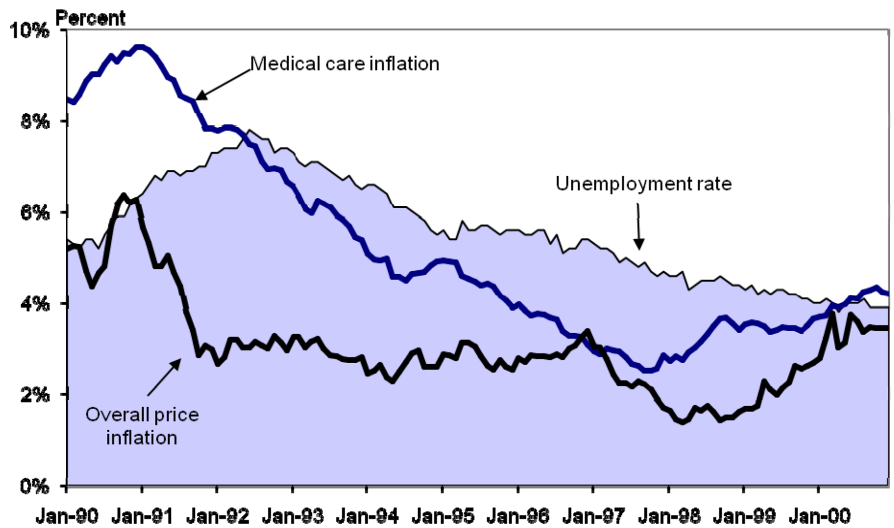


Source: CEA calculations.

Another possible macroeconomic effect of cost growth containment is a short-run impact on unemployment and employment. When health care costs are growing more slowly, wages can grow without firms' costs rising, so firms do not raise prices as much. This allows monetary policy to lower the unemployment rate while keeping inflation steady. Our estimates suggest that slowing cost growth by 1.5 percentage points per year would lower normal unemployment by around ¼ of a percentage point. This translates into an increase in employment of about 500,000 jobs. While this is almost surely not a permanent effect, it could last for a number of years.

Studies find that this mechanism was one source of the unusual prosperity of the 1990s. This figure (Figure 16 from the report) shows medical care inflation, overall inflation, and the unemployment rate in the 1990s. Greater attention to costs and widespread changes in the nature of health insurance led to a period of much lower health care cost growth. The growth rate in medical care prices slowed from about 10 percent at the beginning of the decade to below 3 percent. The unemployment rate also fell steadily over this period. Formal studies suggest that there was a linkage between the two and that the impact of slowing health care costs on the unemployment rate were quantitatively significant.

Figure 16: Unemployment Rate and Medical Care Inflation in the 1990s



Source: Bureau of Labor Statistics.
Note: Medical care inflation is the 12-month change in CPI-U: Medical Care, and overall price inflation is the 12-month change in CPI-U: All Prices.

The Economic Impact of Coverage Expansion

The report also discusses the benefits of coverage expansion. The most important of these involves the economic well-being of the uninsured. We use the best available estimates to try to quantify the costs and benefits of expanding coverage to all Americans. Among the benefits we attempt to put a dollar value on are the increase in life expectancy and the decreased chance of financial ruin from high medical bills. The costs to society of covering the uninsured represent a mix of public and private costs and come from existing studies, not estimates of plans currently being contemplated by Congress. We find the benefits of coverage to the uninsured are very large and substantially greater than the costs. Our estimates show that the net benefits—the benefits minus the costs—are roughly $100 billion per year, or about 2/3 of a percent of GDP.

Another effect of expanding coverage that we consider is increased labor supply. With full health insurance coverage, some people who would not be able to work because of disability would be able to get health care that prevents or effectively treats the disability. They would therefore be able to stay in the labor force longer. A related effect is that some workers currently in the labor force would be more productive with better health care. How large these effects might be are hard to predict. And, there could be offsetting effects: for example, with a better insurance market some workers who are working just to get health insurance might retire earlier. But, we believe that the net impact on effective labor supply will be positive and will further increase GDP.

The final impact that we identify is the effect of expanding coverage on the efficiency of the labor market. Expanding coverage and eliminating restrictions on pre-existing conditions would end the phenomenon of "job lock," where worries about health insurance cause workers to stay in their jobs even when ones that pay more or are a better match are available. Our estimates, based on a range of economic studies, are that this benefit could be about 2/10 of a percent of GDP each year. Similarly, we examine the fact that small businesses are currently disadvantaged in the labor market because current employer-sponsored insurance is so expensive for them (due in large part to the fact that they do not have a large workforce over which to pool risk). Moving to an insurance system that removes this disadvantage should be beneficial to the competitiveness of the crucial small business sector of the economy.

The bottom line of our report is that doing health care reform right is incredibly important. If we can put in place reforms that slow cost growth significantly and expand coverage, the benefits to American families, firms, and the government budget would be enormous. To put it simply, good health care reform is good economic policy.