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INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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# PRESCRIPTION DRUG MEANS TEST MEANS HIGH MARGINAL TAX RATES

## *Executive Summary*

Means testing has been suggested to bring down the costs of the prescription drug bills. That may be necessary, but income tests have the effect of imposing severe tax penalties on earning additional wages or saving for retirement. That is certainly true in the House and Senate drug plans, which provide special low income benefits (waivers of premiums and deductibles, and reduced copayments) that are withdrawn as incomes rise.

Similarly, the asset tests in the bills would encourage low income people to spend down, give away, or hide their excess assets, rather than lose the substantial low income subsidy year after year. Likewise, the limitation on the catastrophic drug expense benefit for upper middle income seniors in the House bill would create an implicit marginal income tax rate spike and discourage work effort. Plans by the House-Senate conference on the bills to add additional upper income means testing would exacerbate these effects.

Consider a participant under the Senate bill whose income is $12,906 (135% of the projected 2006 poverty level), and who spends $4,500 on drugs:

- If he earned an extra $2,400 or withdrew that amount from an IRA, he would lose $2,571 in waivers of low income premiums and copayments. That's an implicit tax of 107 percent of the added income.

- If his drug spending were at the catastrophic spending threshold of $5,813, he would lose a $3,752 subsidy by earning $2,400 more income, an implicit tax rate of 156%.

For upper income seniors, the out-of-pocket requirement for triggering catastrophic benefits under the House bill rise by $8,100 as income grows from $60,000 to $200,000, an implicit add-on marginal tax rate of 5.83%. With federal and state income taxes and the payroll tax, working seniors could be paying 43 percent to 50 percent tax on their added income.

Many Medicare recipients choose not to work, and those with very high requirements for prescription drugs may be too ill to work even if they wanted to. Nonetheless, the added disincentive effect of high implicit tax rates under the catastrophic drug feature could discourage others who wish to work from doing so. The presence of means testing also dis-rewards those who save for retirement.

## PRESCRIPTION DRUG MEANS TEST
## MEANS HIGH MARGINAL TAX RATES

**The House and Senate prescription drug bills.**

The prescription drug plans that passed the House (H.R.1) and the Senate (S.1) offer a prescription drug benefit in exchange for modest premiums and copayments that will cover only a fraction of the total cost of the medications. The Federal government will kick in an additional $400-plus billion dollars over ten years to make up the difference, covering roughly 70 percent of the outlays under the Senate bill and about 73 percent of outlays under the House plan, according to Congressional Budget Office estimates.

Each plan would charge beneficiaries a monthly premium and require participants to pay a modest deductible covering all of their first few hundred dollars of drug outlays. Additional spending of up to several thousand dollars in prescription costs would be mostly covered by the government with a small percentage copayment due from the patient. Beyond this initial benefit limit, the patient would be responsible for all outlays up to a "catastrophic" ceiling, after which the government would again cover most or all additional outlays. (See Table 1.)

In 2006, the House bill would have a monthly premium of $35.50 ($426 a year) and a $250 annual deductible; cover 80 percent of additional drug costs up to a $2,000 initial benefit limit (leaving 20 percent of $1,750, or $350, due from the patient); provide no additional coverage until an individual has spent $3,500 out-of-pocket (which would occur when total drug purchases reached $4,900); then provide "catastrophic" coverage of 100% of costs above $4,900.

In 2006, the Senate bill would have a monthly premium of $34 in 2006 ($408 a year) and a $275 annual deductible; cover 50 percent of additional drug costs up to a $4,500 initial benefit limit; provide no additional coverage until an individual has spent $3,700 out-of-pocket (at total drug purchases of $5,813); then provide "catastrophic" coverage of 90% of costs above $5,813.

**Additional low income assistance.**

Lower income participants would be granted additional help if their incomes and their assets were below certain levels. Their premiums would be eliminated or reduced, their copayments for prescription outlays would be reduced, and, under the Senate bill, outlays in excess of the basic benefit cap but below the catastrophic benefit level would be partly covered for them.

The amount of subsidy a low income participant could receive would depend on his or her prescription drug use. Low income premium relief is part of both bills. Additional low income savings would range from zero with no drug use to various upper limits. In the House bill, the added relief would depend on the number of prescriptions filled. The additional savings in the Senate bill would be a percentage of prescription drug outlays.

House bill. The additional subsidies for lower income participants in the House bill are relatively simple. For people below 135% of the poverty level (and with limited assets), the House bill would waive the annual premium ($426), the deductible ($250), and the percentage copayment on the first $2,000 in annual outlays ($350), saving a maximum of $1026. These charges would be replaced by a copayment of $2 per generic prescription and $5 per brand name prescription. As illustration, a patient using ten of each type of prescription per year would owe $70 in copayments, instead of up to $1026 in premiums, deductibles, and copayments for higher income participants, for a net additional subsidy or $956 compared to higher income participants.

The premium subsidy would be phased out for people with incomes between 135% and 150% of the poverty level. The copayment reductions would continue until 150% of the poverty level, and then end abruptly. Low income relief would not be available if the asset test were not satisfied (assets less than $6,000 for an individual and $9,000 for a couple in 2006, adjusted for inflation thereafter).

**Table 1: House and Senate Drug Proposals**

| House Bill | | | | Senate Bill | | | |
|---|---|---|---|---|---|---|---|
| Monthly Premium | | $35.50 in 2006 ($426 a year) | | Monthly Premium | | $34 in 2006 ($672 a year) | |
| Drug Spending | Coverage | Max Paid by Indiv. | Max Paid by Govt. | Drug Spending | Coverage | Max Paid by Indiv. | Max Paid by Govt. |
| $0-$250 | deductible | $250 | $0 | $0-$275 | deductible | $275 | $0 |
| $250-$2,000 | 20% copay/ 80% govt. | $350 | $1,400 | $275-$4,500 | 50% copay/ 50% govt. | $2,112.50 | $2,112.50 |
| $2,000-$4,900 | 100% copay | $2,900 | $0 | $4,500-$5,813 | 100% copay | $1,313 | $0 |
| *Subtotal: maximum outlay before catastrophic benefit (excl. premium)* | | *$3,500* | *$1,400* | *Subtotal: maximum outlay before catastrophic benefit (excl. premium)* | | *$3,700.50* | *$2,112.50* |
| over $4,900 | cata-strophic | 0% | 100% | over $5,813 | cata-strophic | 10% | 90% |

Senate bill. The additional subsidies for lower income participants are relatively complex. (They are, in fact, one of the fussiest bits of "policy wonkery" I have seen in 28 years of work in Washington.) The Senate premium ($408 a year) would be waived for people with incomes below 135% of the poverty level, and phased back in gradually for people with incomes between 135% and 160% of the poverty level, regardless of assets.

Some deductible and copayment relief would be withdrawn in abrupt steps at 100%, 135%, and 160% of the poverty level, or if the asset test were not met. The $275 deductible would be waived for people below 135% of the poverty level who met the asset test, and would be lowered to $50 for those who do not meet the asset test. The deductible would revert to $275 at 160% of the poverty level. The Senate's asset test is $4,000 for an individual, $6,000 for a couple in 2006-2008; $10,000 for an individual, $20,000 for a couple in 2006, adjusted for inflation thereafter.

For those who meet the asset test, and have income of less than 100% of the poverty level, copayments would be reduced to 2.5% below the initial benefit cap (vs. the regular 50%), 5% above that cap and below the catastrophic cap (vs.100%), and 2.5% above the catastrophic cap (vs. 10%). For those who meet the asset test and have income between 100% and 135% of poverty, the corresponding copayments would be 5%, 10%, and 2.5%. For individuals with income below 135% of the poverty level who do not meet the asset test, and for individuals between 135% and 160% of the poverty level regardless of assets, the corresponding copayments would be 10%, 20%, and 10%.

**Tax rate consequences of means testing.**

Many federal benefits, exemptions, and credits are phased out as incomes rise. Whenever that occurs, the phase-out imposes an implicit additional tax on the extra income that triggers the loss of the benefit or deduction. The phase-outs in the House

and Senate Medicare prescription drug plans are no exceptions. The loss of the low income subsidy as incomes rise, and the additional outlay required of upper income seniors before catastrophic coverage is triggered in the House plan, would constitute implicit taxes on the additional income that was causing the benefits to decline.

If the poverty guideline increases at the average rate of the last five years, by 2006 it will reach almost $9,600 for an individual (a projection, not a dollar amount specified in the legislation). (Medicare is a program that is operated per individual beneficiary, even for married persons.) The low income benefits would be phased out between 135% and 150% of the poverty level under the House bill, and between 100% and 160% of the poverty level under the Senate bill. The key income levels are: 100% of poverty = $9,600, 135% = $12,960, 150% = $14,400, 160% = $15,360.

Under the House bill, at $2,000 in prescription drug use, the low income participant would lose a $956 subsidy if his or her income rose from $12,960 to $14,400, an increase of $1,440, which is an implicit 66.4% tax rate on the added income. The implicit tax would be lower if the individual's drug use and corresponding low income subsidy were lower.

A similar loss of benefits would occur if assets were $1 over the asset test limits. Calculating a tax rate on the last dollar plus one of allowable assets is not really meaningful. Instead, consider the impact of the asset test on a retiree with $7,000 in assets, $1,000 over the House asset test. At today's low interest rates, the drug beneficiary would be lucky to receive $30 a year on the "excess" savings, and it could cost him or her a $956 low income subsidy. The saver would find it better to spend down or give away the excess assets than lose that subsidy year after year.

Under the Senate bill, a participant with $4,500 in drug spending would lose $2,571 in low income subsidies as his income rose $2,400, from $12,960 to $15,360, constituting an implicit 107% tax rate on the added income. If his drug spending were at the catastrophic spending threshold of $5,813, his subsidy would be $3,752 if his income is 135% of the poverty level and zero at 160% of the poverty level; this would be an implicit tax rate of 156% on the $2,400 income gain.

Normally, one would expect these high implicit tax rates to lower work effort and discourage saving, especially when added to the ordinary tax rates these individuals face on any incremental earnings. Some part time or low wage workers who choose to defer drawing Social Security retirement benefits past age 65 might still be earning a fair bit of income. They could face the loss of drug subsidies at the margin on $9,000 to $16,000 of earnings. These workers would have to contend with an additional 7.65% payroll tax rate, plus a 10% federal income tax rate, plus their state tax rates, on top of the up to 156% implicit tax rate under the low income subsidy phase-out. If they are healthy enough to work, the implicit tax penalty from loss of benefits could discourage them from trying. They will certainly be encouraged to spend down or hide assets.

There are some mitigating circumstances, however. In many cases, the elderly beneficiaries would simply not be in the labor force, either due to age or actual illness. They would only face penalties on their savings income, not wage income. Also, many would have Social Security benefits nearly as large as the incomes that lead to loss of benefits. Figures in the 2003 Social Security Trustees Report indicate that the "scaled low wage" retiree in 2006 will have Social Security retirement benefits of about $9,000, about equal to the poverty level, and the "scaled median wage" retiree, about $15,000. Modest amounts of additional part time earnings above their Social Security receipts, even amounts too low to be subject to income tax, would cause the recipients to lose all the special low income prescription drug subsidies. At that point, there would be no impact "at the margin" on additional earnings for work effort.

**Upper income tax rate spike.**

The House bill would require beneficiaries with incomes above $60,000 to incur higher out-of-pocket outlays before the catastrophic protection would kick in (with married beneficiaries splitting their joint income with their partners in determining their catastrophic limit). In 2006, the out-of-pocket

requirement for triggering catastrophic benefits would rise from $3,500 for a beneficiary with $60,000 in income to $11,600 for a beneficiary with $200,000 in income.

The extra $8,100 in drug charges spread over $140,000 in additional income would create an implicit add-on marginal tax rate of 5.83%. These taxpayers would likely be in the 25% federal income tax bracket. Their state income tax might add another several percentage points, perhaps 5% in a typical state, over 9% in California. Together, these beneficiaries would face an implicit marginal income tax rate of between 35% and 40% on pension, interest and dividend income. They may also be paying payroll taxes if they are still working, taking another 7.65% on incremental earnings (15.3% if self-employed). Their combined effective marginal tax rate on earnings could range from 43% to 50%.

**Conclusion**

Many Medicare recipients choose not to work, and those with very high requirements for prescription drugs may be too ill to work even if they wanted to. Nonetheless, the added disincentive effect of high implicit tax rates under the phase-out of the low income benefits and the upper income catastrophic drug penalty could discourage others who wish to work from doing so. Plans by the House-Senate conference of the bills to add additional upper income means testing would exacerbate these effects. The means testing and assets limits would also punish those who were frugal during their working years and saved for their retirement.

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