IRET Congressional Advisory

July 5, 1994 No. 34

HEALTH PLANS FROM WASHINGTON WOULD CREATE A DEPENDENCY TRAP

Most of the government controlled health insurance plans now being debated in Washington would provide low-income individuals with subsidies for purchasing a government-approved insurance package. The complex and sweeping plan that the Clintons' introduced last year would require everyone to obtain government-specified health insurance but would provide an assortment of subsidies to low-income individuals and small, low-wage firms. Those elements have been retained, albeit with many modifications, in several Congressional proposals which acceded to the Clintons' plan as their starting point. Congressional offspring of the Clintons' plan have now passed the Senate Education and Human Resources Committee, chaired by Sen. Edward Kennedy (D-Mass.), the House Education and Labor Committee, chaired by Rep. William Ford (D-Mich.), and the House Ways and Means Committee, chaired (on an acting basis) by Rep. Sam Gibbons (D-Fla.). The Senate Finance Committee approved a plan offered by self-styled "centrist" members that features radical changes in how insurance policies are written and that contains a low-income subsidy. Sen. Robert Dole (R-Kan.) has drafted a plan that also calls for subsidized coverage of low-income individuals.

Although low-income subsidies may seem appealing ... they have the unfortunate disadvantage that they erode normal incentives to work and save...Surprisingly, some of the sharpest disincentives would fall on the poor and the lower-middle income class...

Although low-income subsidies may seem appealing at first glance, they have the unfortunate disadvantage that they erode normal incentives to work and save. First, the granting of subsidies would reduce or take away what would otherwise be an important reason to work and save. High quality health insurance is now a reward for work and saving. Under the Clintons' plan and many others, those who did not work or save would receive, for free, the same health insurance everyone else has to pay for. Because of this giant new government entitlement program, health insurance would cease to be a reward for effort because some people would be given health insurance without ever needing to work or save. Second, all the major plans proposed in Washington would phase out the low-income subsidies as income rises. That would actively penalize working and saving. In many of the plans, working and saving would bring only punishment: those who worked and saved would be subject to higher taxes, but receive the same health insurance as those who did not. Thus, the proposed health insurance entitlement would turn incentives upside down.

Surprisingly, some of the sharpest disincentives would fall on the poor and the lower-middle income class, rewarding them for dependency and penalizing them for effort. This is because, in all of the plans, the low-income health insurance subsidies would phase out with increases in income. In effect, the poor and near poor would face a new, special tax on their work and saving. This new government penalty for working and saving would be in addition to the many taxes and subsidy phaseouts now on the books that already discourage the poor and near poor from trying to earn additional income.

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the free market economy.

1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

The Clintons' plan[1] provides a good illustration of this undermining of the efforts of the poor and near poor to attain self-reliance. Although other plans would not generate exactly the same numbers, the granting of low-income subsidies and then their phaseout with increasing income guarantees that all the plans would exert a bias against work and saving.

The Clintons' plan contains a very complicated grab bag of low-income subsidies. Some would reduce the family-share "premium". (The family-share "premium", in the plan's jargon, is the charge assessed at the household level rather than that imposed on employers. Despite the Administration's characterization of this amount as an insurance premium, it would, in reality, be a tax.) Others would place a cap on the employer-share "premium" (which is really a payroll tax on employers that would be shifted to workers through lower pay.)

...the Clintons' plan would appreciably hike the effective marginal tax rate of most people with below average incomes.

For an idea of how the family-share "premium" subsidy would operate, consider a husband and wife with two children. To make the calculations more realistic, the Congressional Budget Office's (CBO's) estimates of health insurance "premiums" are substituted for those of the Administration.[2] (The CBO's estimates are from 5% to 27% higher than the Administration's, depending on the class of family.) Also, the CBO's estimates are updated here to 1995 amounts because if a plan were to be enacted late this year, that is the earliest it could begin.[3]

In the Clintons' plan, the family-share "premium" would be waived if the family's adjusted gross income were below a so-called "income threshold amount" (the Clintons' phrase), which the plan sets at $1,000 in 1994 dollars. As soon as the family's income crossed this extremely low threshold, the Clintons' plan would start phasing out the subsidy and the family would, as a matter of law, have to use some of its income to buy health insurance. If the family's income were between this "threshold" and the poverty level, the subsidy would be phased out at the "initial marginal rate" (also the Clintons' phrase), which is based on an (arbitrary) formula incorporating the poverty level. One can estimate this first phase-out rate: it would be 3.2% in 1995.[4] Thus, for every dollar of the family's income in 1995 between $1,030 (equal to $1,000 in 1994 dollars) and $15,200 (an estimate of the poverty level in 1995 for a four-person family), the family would have to pay 3.2 cents towards the family share "premium".

The Clintons' plan contemplates that this would usually be paid through withholding at the workplace. In effect, this subsidy phaseout would boost the family's marginal tax rate by 3.2 percentage points. For instance, if the family in the example began with an income of $13,000 and then earned an extra $100 though additional work, the family would see its payroll withholding rise by $3.20 due to the family-share "premium", in addition to all the other increases in payroll withholding that would be required due to other taxes. At an adjusted gross income of $13,000, the family's effective marginal tax rate due to other tax provisions would be 35.5% in 1995.[5] The phaseout of the low income subsidy in the Clintons' health plan would raise this to 38.7%. As a result of this tax wedge, the $100 of extra income would be worth only $61.30 on an after-tax basis, severely diminishing the family's work incentive.

Above the poverty line, the Clintons' plan would shift to a second, much higher phaseout rate. This second phaseout rate (which the Clintons' plan calls the "final marginal rate") is based on another (arbitrary) formula that incorporates the poverty level and the family-share "premium". This rate can also be estimated; it would be 9.4% in 1995. For instance, if the family in the example had an income of $17,000 in 1995, the last $100 of its income would raise its family-share "premium" (i.e., lower its subsidy) by $9.40 (9.4% of $100). The phaseout of the low-income subsidy would effectively boost the family's marginal tax rate by 9.4 percentage points. This is a very large tax spike for a family with such a low income. At this adjusted gross income, the family's effective marginal tax rate from other tax provisions would be 50.5% in 1995.[6] The phaseout of the low income subsidy in the Clintons' health plan would loft this to 59.9%. Consequently, the $100 of extra income would be worth only $40.10 to the family on an after-tax basis.

The Clintons' plan contains the additional restriction that the family-share "premium" may not exceed 3.9% of income for families with incomes below $40,000. The family in the example would reach that limit at an income of $17,700. That introduces a third marginal rate in the example: between incomes of $17,700 and $29,970, every extra dollar the family earned through work or saving would raise its family-share "premium" by 3.9 cents, an effective marginal tax rate of 3.9 percent. Although the Clintons' describe the phaseout as being completed at 150% of the poverty level, the presence of the cap would cause the phaseout to continue well beyond that point in this example.

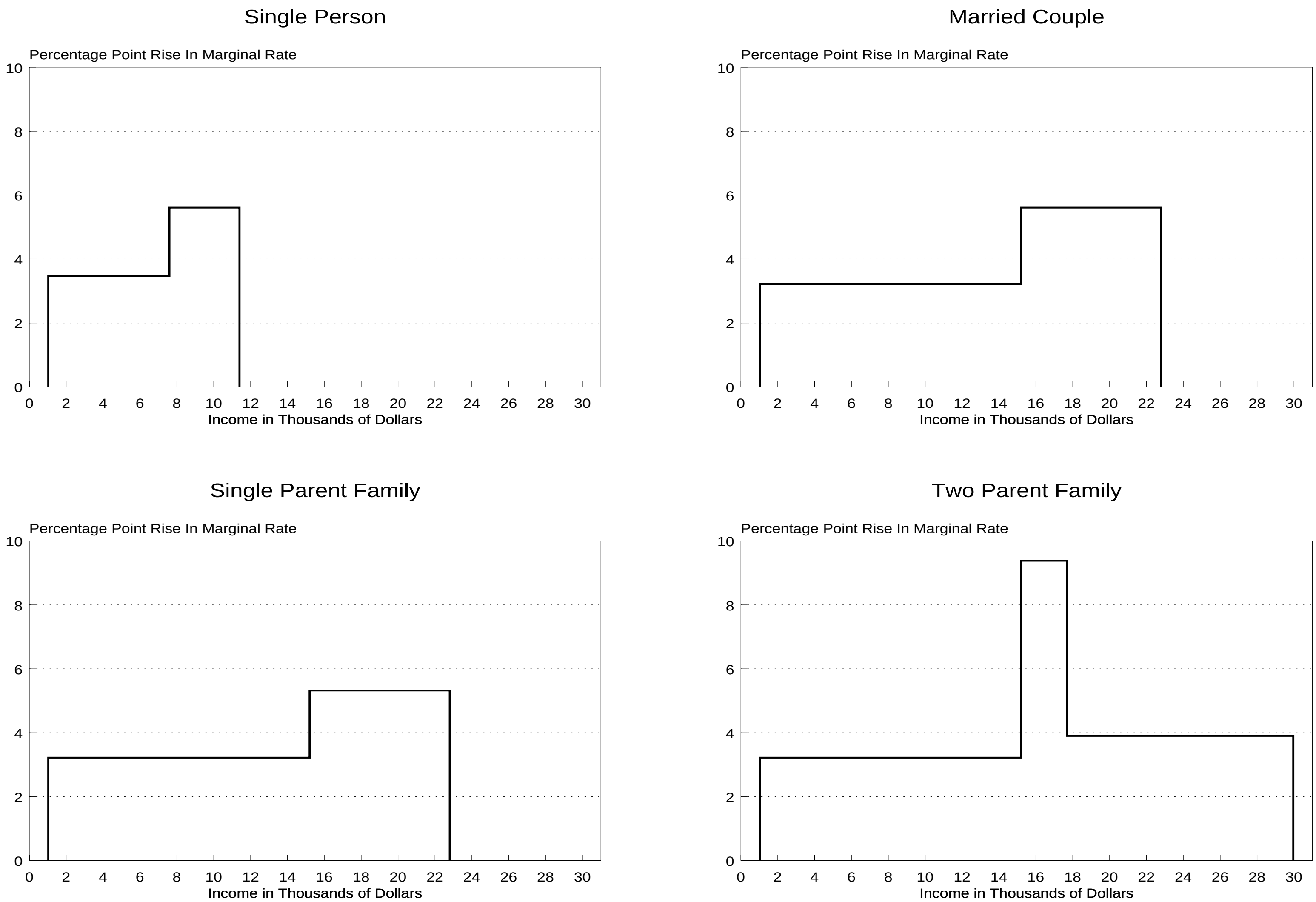
For people trying to leave welfare, the suddenly imposed cost [of the health subsidy phaseout] would be a financial cliff; it would certainly be one more government-imposed reason for them not to jeopardize their AFDC or SSI eligibility by working or saving "too much".

The charts on the next page show by how many percentage points the phaseout of the family subsidy would effectively increase marginal tax rates for several classes of families.[7] With the exception of people on cash welfare programs (the disincentive to them is described in the next paragraph), the Clintons' plan would appreciably hike the effective marginal tax rate of most people with below average incomes. Further, the second phaseout rate (the "final marginal rate" in the plan's jargon) is very sensitive to "premium" size. If the program's costs are higher than the optimistic assumptions of the Administration and the CBO, the second phaseout rate would be much stiffer. In the past, government revenue estimators have underestimated by orders of magnitude the expenses of programs like Medicare, Medicaid, and Social Security.

The Clintons' plan and many of its descendants would exempt recipients of Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) from the phaseouts. While remaining on AFDC or SSI, these people could earn income without seeing their health insurance subsidies fall. However, as soon as they earned sufficient income or accumulated enough assets to lose their eligibility for AFDC or SSI, they would immediately lose the exemption and become fully subject to the health subsidy phaseout. That could cost them several hundred dollars or more in mandatory family-share "premiums". For people trying to leave welfare, the suddenly imposed cost would be a financial cliff; it would certainly be one more government-imposed reason for them not to jeopardize their AFDC or SSI eligibility by working or saving "too much".

To be sure, the tax penalty for working and saving could be softened for the poor and near poor by phasing out the family subsidy at a lower rate over a broader income range. Most of the Clinton-like plans would do that. The House Ways and Means proposal would extend the family-share subsidy to approximately 240% of the poverty level. The plan from the House Education and Labor Committee would double the income level at which the phaseout began and would continue the family-share subsidy to 200% of the poverty level. Senate Finance Committee Chairman Moynihan's proposal also would have extended the family-share subsidy to 200% of the poverty level. Unfortunately, a more gradual phaseout would create a serious problem elsewhere: the subsidy would then extend even farther into the middle class, and its prolonged

Increase In Effective Marginal Tax Rate Due To Phase Out Of Family Subsidy In The Clintons' Health Plan



EXCEPTION: No Phase Out and No Marginal Tax Rate Increase for Those on AFDC or SSI

Sources: *Health Security Act*, H.R. 3600, introduced in the House of Representatives on November 20, 1993; The Congressional Budget Office, *An Analysis Of The Administration's Health Proposal*, February 1994, p. 30; and calculations by author.

phaseout would raise effective marginal tax rates for a substantial portion of the U.S. population. The House Education and Labor Committee confirms that millions more people would be in the subsidy phaseout range when it boasts, "By raising the eligibility threshold to 200% of poverty, 19 million more individuals and 9 million more families would qualify for premium subsidies."[8]

Another option would be to drop the phaseout entirely. The drawback there is that while the phaseout would no longer be present to elevate marginal tax rates, other taxes would probably be raised to compensate for the foregone revenues. It would be crucial to know which taxes those were. If the tax increases followed the pattern of 1993, the new levies would be strongly biased against work and saving. On the other hand, the tax system could actually be made more neutral if employees were no longer allowed to exclude employer-paid health insurance from income while employers simultaneously deducted it as an expense.

A plan often mentioned as an alternative to Clinton-style plans is that of Rep. Jim Cooper (D-Tenn.). The Cooper plan has an extremely generous subsidy, and, consequently, would generate a much higher effective marginal tax rate than the Clintons' proposal. Under Cooper's plan, the government would pay the total cost of a health insurance policy (not just an employee share of approximately 20%) for those below the poverty level. It would phase out the subsidy at incomes between the poverty level and double the poverty level plus the premium. Feldstein has examined this plan.[9] He calculated that a woman with one child who has an income of $15,000 would face an additional marginal tax rate of 19% under the Cooper plan due to the phaseout of the low-income subsidy. When that is added to the 46% marginal tax rate she now confronts due to the individual income tax, social security taxes, and the phase out of the earned income tax credit, it would lift her total marginal tax rate to 65%. For a couple with two children, Feldstein computes that Cooper's plan would boost their total marginal tax rate to 72%.

Feldstein warns that the plan of Sen. John Chafee (R-RI) would also produce phenomenally high marginal tax rates. The proposal pieced together by the Senate Finance Committee "centrists" likewise appears to suffer from this serious defect. It would pay "individuals and families with incomes less than 100% of poverty ... 100% of the average premium" of the health plans in their area.[10] For people with higher incomes, it would totally phase out the subsidy between 100% and 240% of the poverty level. Sen. Dole's plan has a low-income subsidy for individuals not currently receiving employer-provided insurance. The subsidy would be phased out between 100% and 150% of the poverty level. For individuals to whom the subsidy applied and who found themselves in the phaseout range, this aspect of the Dole plan would seem to produce high marginal tax rates.

Employer subsidies are found in the Clintons' plan and most of its offspring. Although the specific details depend on the plan, the Clintons' plan is illustrative. It would cap the employer-share "premium" at a maximum of 7.9% of payroll and set lower caps for small, low-wage firms. If not for these subsidies, the Clintons' plan would have an absolutely devastating effect on employment among the poor and near poor. Mandatory enrollment in a rich health plan would take a very large chunk of the total amount that employers are willing to pay low-wage workers (the total amount is based on worker productivity and would not increase with government-mandated health insurance). Many current workers would find the new compensation mix (very heavy on health coverage and correspondingly light on everything else) to be insufficient reward for working — particularly because the Clintons' plan would give them full health coverage without working. In cases where minimum wage laws prevented employers from shifting the "premiums" to workers through lower pay, the extremely sharp climb in the expense of hiring low-wage workers would cost many of those workers their jobs. Although it would cushion the blow, capping the employer "premium" as a percentage of payroll would not eliminate the job-killing nature of the employer mandate. Many low-wage workers would still lose their jobs. And all workers who would have preferred to receive more compensation in other forms, often because they are healthy or have medical coverage through other family members, would be worse off.

In the Clintons' plan, the subsidy at the employer level would be based on a firm's average payroll, not on each worker's pay. Thus, if a business employs workers whose average pay is moderately high, employer-share "premiums" would average less than 7.9% of payroll and there would be no subsidy for low-wage workers within that firm. In its analysis of the Clintons' plan, the CBO expects this would lead firms with high average wages to shed many of their low-wage workers. Some of these workers would find employment elsewhere, tending to congregate in firms with low average wages; some would remain unemployed. This artificial segregation of the workplace by wages would be disruptive, both wasting resources that could have been used in the production of goods and services and forcing many low-wage workers to scramble for new, unfamiliar jobs.

Of course, employer "premium" subsidies are not obtained for free. The Clintons' plan and its progeny use various ad hoc, offsetting revenue raisers. These arbitrary levies would tend either to increase labor costs or reduce profits, which would cause decreases in employment and investment. But these proposed taxes are mostly hidden, and that enhances their political appeal.

Inescapably, health insurance subsidies, which are a central element of the Clintons' plan, various Clinton-like plans, and several other plans being discussed in Washington, must diminish work and saving incentives. In these plans the phase out of low-income subsidies, coming in addition to all other taxes, would appreciably deepen the dependency trap into which a variety of often well-intentioned government programs have cast the poor and near poor.

If one seeks reforms that would help people without punishing them for being productive, subsidies are not the answer.

Michael A. Schuyler
Senior Economist

. . . .

Endnotes

1. H.R. 3600, introduced in the House of Representatives on November 20, 1993 by House Majority Leader Richard Gephardt.

2. See Congressional Budget Office, *An Analysis Of The Administration's Health Proposal* (Washington, DC: Government Printing Office, February 1994), p. 30.

3. The CBO guesses that the total "premium", excluding subsidies, for an average cost health insurance plan for a two-parent family would be $5,565 in 1994. Of this, the employee-share "premium" would be 20 percent, or $1,113. To account for medical cost inflation, the CBO's estimated "premiums" for 1994 are increased here by 5 percent, which is about the rate that the medical service component of the CPI has risen in the past year. Thus, for 1995, the estimated total "premium" becomes $5,843 and the estimated employee-share "premium" becomes $1,169.

4. The estimate is based on: (1) the formula for the "initial marginal rate" contained in the Clintons' proposal, (2) the CBO's estimate for the family-share premium, and (3) an estimate for the poverty level in 1995. The calculations performed here take the most recent poverty level figures and increase them by 3 percent to inflate them to 1995 levels. (In some numerical examples the Clinton Administration released, it used last year's poverty levels.)

5. These provisions are the social security payroll tax (both the employee and employer shares) and the phaseout of the earned income tax credit (using the 1995 phaseout rate). Assuming the family has two children and claims the standard deduction, it would have no income tax liability, and, accordingly, its marginal income tax rate would be zero.

6. These provisions are the social security payroll tax (both the employee and employer shares), the phaseout of the earned income tax credit (using the 1995 phaseout rate), and the individual income tax.

7. A peculiarity of the Clintons' plan is that its phaseout formulas for couples and single parent families do not use their poverty levels but substitute in the poverty level for two-parent families. Because the poverty level for two-parent families is higher than those for couples and single parent families, couples and single parent families would still be receiving low-income subsidies at incomes far above 150% of their official poverty levels (about 225% for couples and 180% for single parent families).

8. See *Daily Tax Report*, June 6, 1994, L-4.

9. See Martin Feldstein, "Income-Based Subsidies Won't Work," *Wall Street Journal*, June 17, 1994, A14.

10. "Updated Summary of Mainstream Health Care Plan Offered by Centrist Members of Senate Finance Committee", reprinted in *Daily Tax Report*, June 29, 1994. In computing the "average premium", the most expensive one-third of area health plans would be excluded from the calculation.