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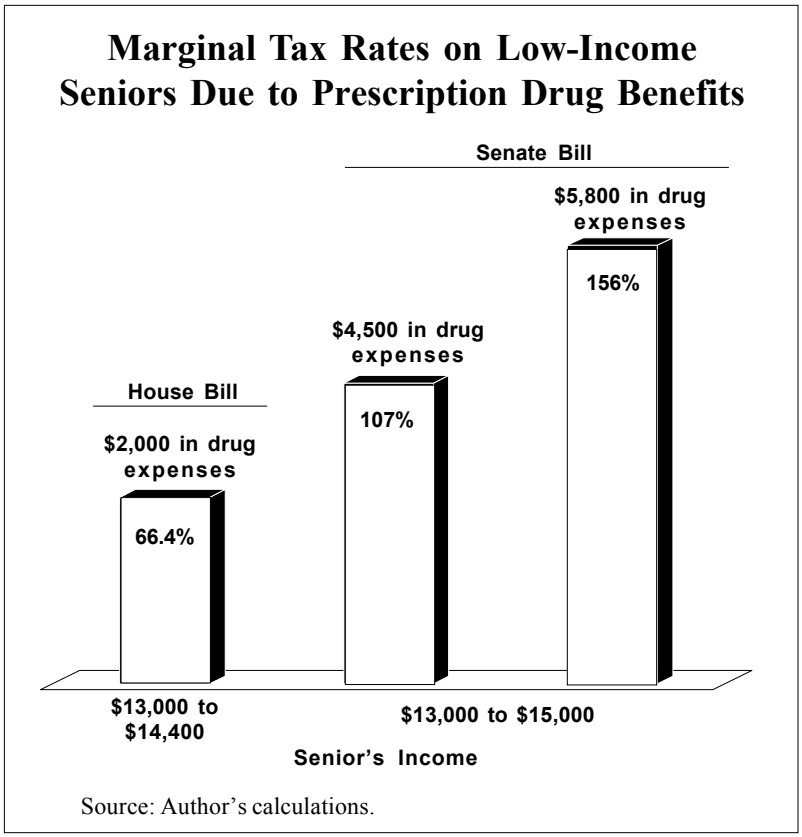
Prescription Drug Means Testing = Higher Marginal Tax Rates

by Stephen J. Entin

The Medicare prescription drug benefit plans that passed the House (H.R.1) and the Senate (S.1) require modest premiums and copayments that will cover only a fraction of the total cost of the benefits seniors will receive. The differing provisions of the two bills are now being reconciled by a House-Senate conference committee. Both would cover a substantial proportion of seniors' drug bills, but not all. Many seniors will still face significant out-of-pocket costs for prescription drugs. Both bills also provide additional help for low-income seniors, but these extra subsidies are withdrawn at rather modest income levels. As a result, seniors just above the poverty level face high implicit tax rates on any additional income.



Source: Author's calculations.

Drug Subsidies for All Seniors. Under either bill, the federal government would subsidize seniors' drug bills by $400 billion or more over 10 years. Each plan would charge beneficiaries a monthly premium and require them to pay a modest deductible for their first few hundred dollars of drug outlays. Additional prescription costs of up to several thousand dollars would be covered mostly by the government with a small copayment from the patient. Beyond this initial benefit limit, the patient would be responsible for all outlays up to a "catastrophic" ceiling, above which the government would cover most or all additional outlays. Overall, the federal government would cover roughly 70 percent of the outlays under the Senate bill and about 73 percent under the House plan, according to Congressional Budget Office estimates. Both plans would take full effect in 2006.

Under the House bill, in 2006 the monthly premium would be $35.50 ($426 a year) and the annual deductible $250. It would cover 80 percent of drug costs above the deductible up to a $2,000 initial benefit limit — leaving $350 due from the patient. It would provide no additional coverage until an individual spent $3,500 out-of-pocket, which would occur when total drug purchases reached $4,900, then it would pay 100 percent of costs.

Under the Senate bill, in 2006 the monthly premium would be $34 and the annual deductible would be $275. It would cover 50 percent of additional drug costs up to a $4,500 initial benefit limit, provide no additional coverage until an individual spent $3,700 out of pocket on total drug purchases of $5,813 and provide 90 percent coverage above that amount.

Extra Help and Higher Tax Rates for Low-Income Seniors. Both drug benefit plans would give extra help to low-income seniors. Their premiums would be reduced or eliminated, copayments would be reduced, and under the Senate bill outlays above the basic benefit cap but below the catastrophic benefit

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level would be partly covered. However, these extra subsidies are cut to nothing for seniors who earn a little extra or have some savings. As a result, seniors with very modest incomes would face higher marginal tax rates than the richest Americans.

For example, take an individual who uses $2,000 worth of prescription drugs per year whose income is 135 percent of the projected poverty level in 2006, or $12,960. Under the House bill, if the senior took a part-time job earning just $120 a month, or received $1,440 from an Individual Retirement Account (IRA), he or she would lose $956 in subsidies — in effect, a tax of 66.4 percent on the additional income.

The Senate bill imposes even higher marginal taxes on some low-income seniors. For example, take a participant with an income at 135 percent of the projected 2006 poverty level ($12,960), with $4,500 in drug spending:

- If the senior took a part time job earning $200 a month, or withdrew $2,400 from an IRA, he or she would lose $2,571 in drug subsidies, for an implicit 107 percent tax rate on the added income. [See the Figure.]
- If his drug spending reached the catastrophic level of $5,813 a year (with a subsidy of $3,752), he would face an implicit tax rate of 156 percent on the $2,400 income gain.

According to the 2003 Social Security Trustees Report, in 2006 a low-wage retiree will receive Social Security benefits of around $9,000, about equal to the projected poverty level ($9,600). The low-income benefits in the Senate bill phase out completely for seniors with incomes between $9,600 and $15,360, or 100 percent to 160 percent of the poverty level. In the House bill, they phase out for seniors with incomes between $12,960 and $14,400, or 135 percent to 150 percent of the poverty level.

Asset Test for Seniors. There are also asset tests for low-income subsidies in each bill — initially, $4,000 in the Senate bill and $6,000 in the House bill. A low-income senior would be ineligible for some or all of the subsidies if he or she has more than this modest amount of wealth. 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, but 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.

Effects of Means Testing Benefits. Many federal benefits, exemptions and credits are phased out as incomes rise. Whenever that occurs, the phaseout imposes an implicit additional tax on the extra income that triggers the loss of the benefit or deduction. The phaseouts 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 due to the additional income before catastrophic coverage is triggered, would constitute implicit taxes on that additional income.

Normally, one would expect high implicit tax rates to lower these individuals' work effort and discourage saving, especially when added to the ordinary tax rates they face on 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, in addition to all the taxes workers pay. The implicit tax penalty from loss of benefits could discourage them from working. It would certainly encourage them to spend down or hide assets.

For people who are drawing Social Security, modest amounts of additional part-time earnings, even amounts too low to be subject to income tax, will put the recipients over the income range at which all low-income prescription drug subsidies will be lost. At that point, there will be less impact "at the margin" on additional earnings for work effort.

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