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Financing Health Care Expansion with "Surtaxes" on High Incomes

An Unsustainable Fiscal Course or A Bet on Increasing Inequality

A proposal in the House of Representatives to expand health care coverage envisions surtaxes on taxpayers with relatively high adjusted gross incomes. Reliance on tax revenue from high-income earners poses a dilemma for proponents of the House health care scheme: The spending and tax provisions in the health-care scheme are unsustainable, leading to ever growing Federal government deficits; or, the scheme proves to be sustainable, but only if income inequality continues to grow.

The Proposal: The House proposal ("America's Affordable Health Choices Act") to expand health-care coverage envisions a surtax on individuals with annual (adjusted gross) incomes above $280,000 and married couples with incomes above $350,000. [i]

Problems with the Proposal: There are a number of reasons not to embrace tax surcharges on upper-income earners.

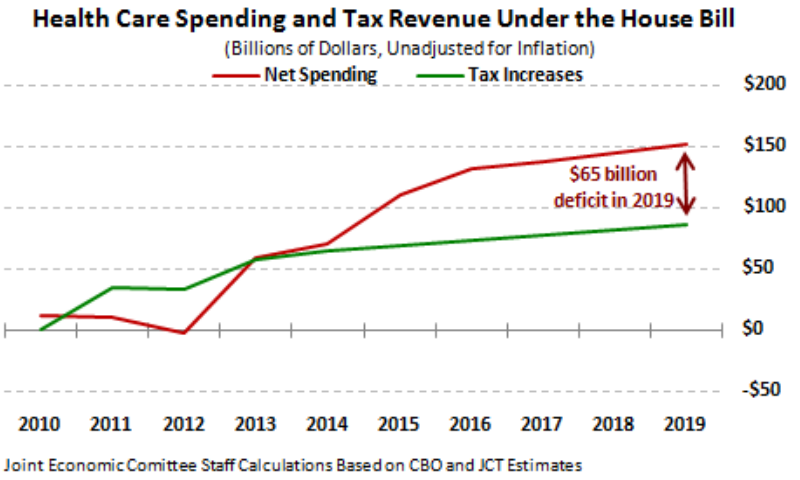
- **Surcharges Impose Punitively High Taxes.** The surtax has been criticized for:
  - Generating statutory tax rates on the highest income earners that would surpass 50% when state income and Medicare taxes are included;
  - Shattering President Obama's pledge that everyone in America will pay lower taxes than they would have in the Clinton era;
  - Imposing high rates on incomes of small business owners who choose, because of the tax code, to pass their business income through the personal tax code rather than the business tax code. For many of those business owners, income stated on the personal tax forms often includes funds that will be reinvested right back into the business. Increasing taxes on that income destroys jobs.

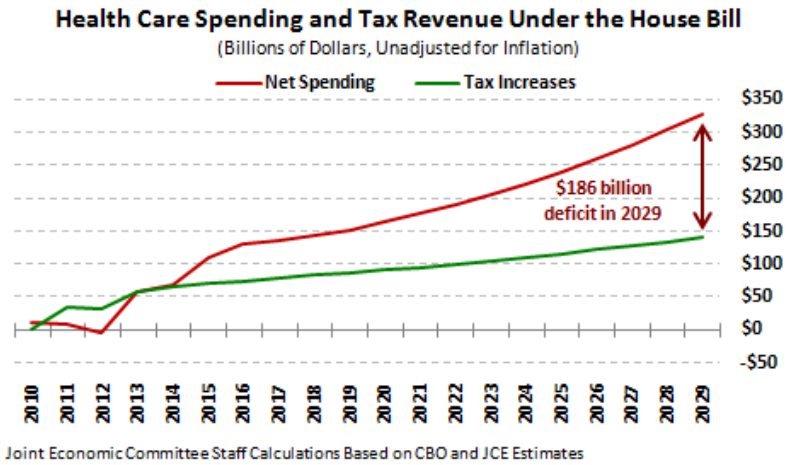
- **Surcharges Build a System that is Either Unsustainable or Relies on Increasing Inequality.** Financing any share of expanded health care spending with the proposed high-income tax base creates potential for a fundamental sustainability problem, a problem that does not show up prominently in 10-year budget "scores" of proposed health-care legislation. However, as experiences in the Social Security system and the Medicare program have shown, when a tax base grows slower than growth in spending, benefit promises become unfunded and deficits mount. Promises embedded in the Social Security and Medicare programs are unsustainable given current payroll tax rates because growth in payrolls has historically fallen short of growth in promised benefits. The only solution is to slow growth in promised benefits or increase taxes or some combination of the two.

Unfortunately, the high-income surtax scheme embedded in the recent House health care proposal could very well embed further unsustainability into funding of government promises or lead to increased income inequality. To see this, note that there are two possible outcomes from the high-income surtax used to finance government promises of increased health care spending:

1. **Revenues Grow Slower then Spending:** The upper-income tax base to which the surtaxes apply will grow at a slower rate than growth in health care spending. In this case, the Federal government deficit will grow ever larger through time.
2. **Revenues Grow Faster than Spending:** The upper-income tax base to which the surtaxes apply will grow at or above the rate of growth of health care spending. This means increases in income inequality.

When The Tax Base Grows Slower than Spending, the System is Unsustainable: According to the Congressional Budget Office (CBO), the House proposal generates the paths shown below between 2010 and 2019 for new net spending by the Federal government on health care benefits (net of proposed savings in the Medicare system) and for tax increases, primarily from tax hikes on high-income earners.[ii]





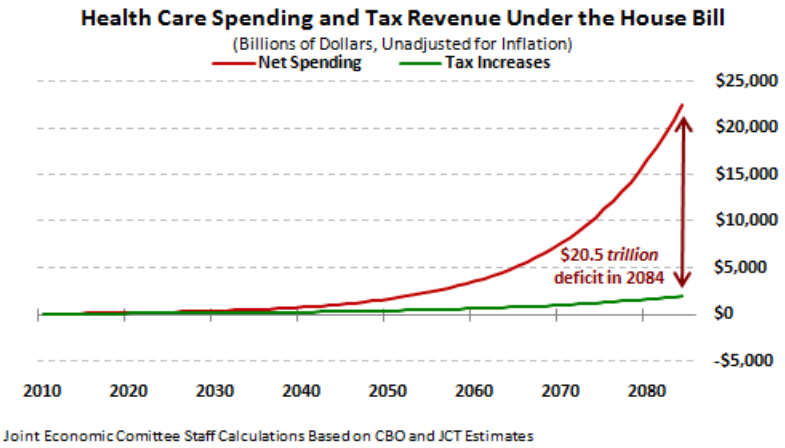
Beyond 2019, it is important to understand how both new spending and tax revenues in the House proposal can be expected to grow.[iii] According to the CBO, net spending "…would be growing at a rate of more than 8 percent per year in nominal [dollars unadjusted for inflation] terms between 2017 and 2019; we would anticipate a similar trend in the subsequent decade." Also, from CBO, "Revenue from the surcharge on high-income individuals would be growing at about 5 percent per year in nominal terms between 2017 and 2019; that component would continue to grow at a slower rate than the cost of the coverage expansion in the following decade."

Using CBO's expectation of over 8 percent annual growth in spending and 5 percent growth in revenues, the figure directly above projects the paths of spending and revenues, and the resulting deficits (which are the vertical gaps between the red spending line and the green tax increases line), over the period 2019-2029.[iv]

Under the growth rates anticipated by CBO, the addition to the Nation's deficit will be $186 billion in the year 2029 alone. This is a large amount, but it pales in comparison to what happens if we

extend further out in time to consider the longer-range effect on the Nation's budget from the House health reform scheme.

When viewing the House health care scheme over a 75-year window if new spending were to continue to grow beyond 2029 at an 8 percent rate, while revenues continue growing at a 5 percent rate, deficits run to over $1 trillion by 2048 and to $20.5 trillion at the end of the window in 2084, as the accompanying figure shows.



The trillions of dollars of future yearly deficits cumulate to enormous amounts of unfunded liabilities. Given the growth rate assumptions used above, the cumulative deficit for the period 2010-2084 arising from the House proposal to grow government health care spending and finance it with surtaxes on high incomes amounts to a staggering $261 *trillion*.

Adjusting for consumer price inflation of 3 percent, the cumulative deficit amounts to $43.6 trillion in 2010 dollars.[v] Adjusting also for expected growth in the general economy, on a net present value basis the 75-year cumulative deficit inherent in the House health care scheme is $9.2 *trillion* in 2010 dollars.[vi] That means that the House scheme, under the growth assumptions used above, would add $9.2 trillion of unfunded liabilities next year to the $51.3 trillion existing combined unfunded liability of the Medicare and Social Security programs over the next 75 years.

Building Up More Unfunded Future Liabilities

Programs	**75-Year Cumulative Deficit (Present Value, 2010 Dollars)**
Existing Medicare	**$46.0 Trillion**
Existing Social Security	**$5.3 Trillion**
New Health Care Entitlement (H.R. 3200)	**$9.2 Trillion**

There are good reasons to expect that the surtax-financed expansion of health care embedded in the House of Representatives proposal will follow a path toward ever growing deficits, as in the example above. Historically, health care spending has grown faster than growth in the economy—the so-called "excess cost growth" in spending on health care. Aside from loose promises of a better future, given the inability of the Administration to come up with effective methods to reduce excess cost growth and "bend" the health care cost curve downward, spending growth in the House health plan could easily outpace income growth in the high-income brackets. Unless growth in incomes in the high-income brackets outpaces growth in the overall economy plus excess health-care cost growth, the House health care scheme is a recipe for growing deficits and an unsustainable system.

When the Tax Base Grows Faster than Spending, Income Inequality Will Grow: If incomes earned in high-income brackets turn out to grow faster than health care costs, then the House health care scheme of taxing high income earners and spending on health care would turn out to be sustainable. However, such a case requires that upper incomes grow at or above the rate of growth of health spending. That is, growth in incomes of high earners would have to outpace growth in the overall economy plus the rate of "excess cost growth" in health care spending. That, in turn, would mean increasing income inequality as high-income earners see their incomes rise at rates faster than growth in the general economy and growth in incomes of low- and moderate-income earners.

While this outcome would be fortuitous for those in the House who advocate the surtax-financed health scheme, it runs counter to public policy objectives of the Administration to arrest growth in income inequality.

What Tax Base Would be Consistent with Sustainability? Because advocates of health care reform wish to fund increased government health care expenditures, a tax base that promises a sustainable program would be one whose growth equals or is likely to always be close to growth in health spending. One obvious candidate is elimination of, or a cap on, tax deductibility of employer-provided health care. Because revenues stemming from eliminating or capping the deduction would grow at the rate of growth of employers' spending on health benefits—which is, after all, close to the rate of growth of health spending—this option would provide a funding source that would not subject government heath care spending to problems of unfunded future liabilities, ever growing deficits, and long-term unsustainablility.

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[i] Individuals making $800,000 and couples making more than $1 million would face a 5.4 percent surtax, starting in 2011. The proposed surtax for certain adjusted gross income (AGI) groups are:

- 1% for $350,000-$500,000 for joint returns for 2011 through 2012; 2% in 2013 and thereafter.
- 1.5% for $500,000-$1,000,000 for joint returns for 2011 through 2012; 3% in 2013 and thereafter.
- 5.4% for $1,000,000 and above for joint returns for 2011 and thereafter.

For unmarried individuals, heads of households, and trusts and estates, the income threshold dollar amounts are 80% of the dollar amounts above. The income thresholds would be indexed for inflation.

[ii] Data on net spending are from CBO's July 17, 2009 letter to Representatives Rangel and Camp (see CBO July 17 letter here); data on tax revenue are from the Joint Committee on Taxation's estimate of revenue effects for the introduced version of H.R. 3200 on June 16, 2009 (see JCX-33-09 at www.jct.gov).

[iii] The net new heath care spending used in the analysis subtracts savings from Medicare in the House bill from planned gross new spending. There are strong arguments to be made that any savings planned for the Medicare program should be applied to the deficits and unfunded future liabilities present in the Medicare program, rather than applied as "savings" to be used toward new government health care spending.

[iv] Some analysts, such as Keith Hennessey (here), have used CBO's anticipation of a continuation of over 8 percent annual growth in spending and 5 percent growth in revenues to project the paths of spending and revenues, and the resulting deficits, over the period 2019 to 2029. We have chosen to use simply 8 percent and 5 percent growth rates, which biases our results toward showing smaller future deficits relative to those found by Hennessey and others.

[v] In discounting future unfunded liabilities of the Social Security and Medicare programs, the Social Security Administration's (SSA) actuaries have most recently assumed long-run future inflation in the consumer price index for wage earners (CPI-W) of 2.8 percent in their "intermediate-cost" assumptions. CBO assumes 2.0 percent long-run future CPI-W inflation in its most recent long-term budget outlook. We choose 3.0 percent given that historically CPI-W inflation has been above what the SSA actuaries and CBO assume for the future and given that assuming higher inflation biases our results toward finding lower current-dollar values of future nominal deficits.

[vi] A 2.9 percent discount rate is used to arrive at present values, consistent with the real interest rate used for discounting in the SSA actuarial report's "intermediate" case analysis of the long-run status of the Social Security and Medicare programs.