The Medicare Catastrophic Coverage Act of 1988 - Reasons for its Premature Failure

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Abstract

At the time of its passage, the Medicare Reimbursement Act of 1988 was hailed as a major improvement in health care funding for the elderly. However, within a year the Act had been repealed largely through the efforts of the elderly citizens it was designed to benefit. This paper examines the problems associated with the funding methods used in this program. It suggests that interaction of the tax surcharge contained in it with other tax provision affecting the elderly made the effects of the law especially objectionable and that future programs for funding national health care program must avoid these effects if they are to succeed.

Introduction

At the time it was passed, the Medicare Catastrophic Coverage Act of 1988 was hailed as one of the major pieces of social legislation of this decade. However, little more than a year after its passage and before it could be implemented, the Act has been repealed by the same Congress that passed it largely as a result of the opposition of many of the senior citizens groups that lobbied for its initial passage. This reversal is due to widespread dissatisfaction among senior citizens with the funding provisions provided in the Act. By charging a supplemental premium based on federal income tax liability to each individual over 65 years of age, these funding provisions effectively raise the marginal tax rates all individuals over age 65 who are subject to federal income tax. Any increase in the marginal rate targeted on this group is already a sensitive issue due to prior legislation providing for the partial taxation of social security retirement benefits. The interaction between the Medicare supplemental premium and social security taxation produces some of the highest marginal tax rates paid by any group of taxpayers under the current rate structure. This paper will examine the structure of effective marginal rates which would have resulted from implementation of this legislation. As a basis for development of these rates, the individual factors which affect them will first be described.

A. Basic Tax Structure

The basic income tax structure which applies to individuals over age 65 is the product of the Tax Reform Act of 1986. The rate structure is comprised of three marginal rates for single and married individual as follows:

Table 1 - 1989 Marginal Tax Rate Schedules

	TAXABLE INCOME OVER:	BUT NOT OVER:	TAX RATE
SINGLE INDIVIDUALS	$0	$18,550	15%
	18,550	44,900	28%
	over 44,900		33%
MARRIED & QUALIFIED WIDOWS AND WIDOWERS	$0	$30,950	15%
	30,950	74,850	28%
	over 74,850		33%

NOTE: The above tables ignore rate structure above the beginning of the 33% bracket. Marginal rates for incomes above this amount will be unaffected by the factors discussed in this paper.

The marginal tax rates developed below apply to single individuals over age 65 and to couples filing jointly (both over age 65). To arrive at taxable income, it is assumed that each of the above individuals will claim the $2000. personal exemption applicable in 1989 and the standard deduction. For 1989, the standard deduction is $3,100 for single individuals and $5,200. for married couples filing jointly. In addition, single individuals over age 65 are entitled to an additional $750. standard deduction and couples over age 65 receive an additional $1,200. standard deduction ($600. each).

B. Taxation of Social Security Retirement Benefits

Prior to 1984, Social Security retirement benefits were not subject to federal income tax. Beginning in that year, benefits became taxable for retirees who exceed a minimum income level up to a maximum of 50% of benefits received. The income test is based on a modified adjusted gross income which adds adjusted gross income to non-taxable municipal bond interest and half of social security retirement benefits. Modified adjusted gross is then compared to a base amount and half of any excess is added to total income, up to a maximum of 50% of social security retirement benefits. For 1989, the base amounts were $25,000 for single individuals and $32,000 for married individuals filing jointly.

For individuals subject to taxation of social security benefits, the effect of the above formula is to increase taxable income by $1.50 for each $1.00 increase in modified adjusted gross income up to the 50% maximum. This effectively increases the individual's marginal tax rate (the percentage rate of tax on an additional dollar of income) to 150% of the rates shown in the basic structure above. These higher rates apply until 50% of social security benefits become subject to tax.

As an example, consider the situation of a single individual over age 65 who receives $8,900 in social security benefits (about the current maximum). No tax would be owed on the first $5850 of income received in addition to social security. The 15% marginal rate from section A would apply to the first $14,700 of additional income, the point at which social security taxation begins. ($14,700 taxable + 5,850 standard deduction (S) and personal exemption (P) + 4,450 (half of social security payment) = $25,000 modified adjusted gross income base amount for single individual). The effective marginal rate increases at this point to 150% of 15%, or 22.5%. This rates continues until the individual reaches $23,116 of income in addition to social security. At this point the tax table rate increases to 28%, based on the individual's taxable income of $18,500, which now includes $1,283 in taxable social security. This rate, coupled with the continued incorporation of social security income into taxable income results in an effective marginal rate of 42%. The 42% effective rate continues until the retiree reaches a taxable income of $28,050, where taxation of social security income reaches the 50% maximum amount ($28,050 taxable + 5,850 standard & personal + 4,450 half of social security - 25,000 base amount = $8,900, half of which is the $4,450 maximum 50% taxable amount of social security retirement). Because no additional social security becomes subject to tax beyond this point, marginal tax rates revert to the amounts shown in section A. The following table summarizes the results described above for a single individual. When translating the results of this table to actual income levels, it should be remembered that pretax income is equal to the amount shown in column 1 plus the individual's $8900. social security retirement benefit.

Married couples filing joint returns face a similar situation. Major differences are: 1)Use of joint tax table rates, 2)Increased standard and personal deductions, 3) Higher social security retirement payments (50% higher than the single rate), 4) Higher base amount ($32,000) used to determine taxability of social security benefits. The net effect of these changes are summarized in Table 3 below:

Table 2 - Effective Marginal Rates, Single Taxpayer over age 65 with $8,900 in Annual Social Security Retirement Benefits.

Amounts shown in Columns 2-5 apply to the maximum income shown in Column 1.

INCOME BEFORE SS (1)	TAXABLE SS INCOME (2)	ADJ GROSS INCOME (1) + (2)	MODIFIED ADJ GROSS (1) + 8900/2	TAXABLE INCOME (3) -S-P	MARGINAL TAX RATE
$0-5850	$0	$5850	$10300	$0	0%
5850-20550	0	20550	25000	14700	15%
20550-23116	1283	24399	27566	18549	22.5%
23116-29450	4450	33900	33900	28050	42%
29450-46300	4450	50750	50750	44900	28%

Table 3 - Effective Marginal Tax Rates for a Married Couple, Both Over Age 65, Receiving $13,350 in Social Security Retirement Benefits.

Amounts shown in Columns 2-5 apply to the maximum income shown in Column 1.

INCOME BEFORE SS (1)	TAXABLE SS INCOME (2)	ADJ GROSS INCOME (1) + (2)	MODIFIED ADJ GROSS (1) +8900/2	TAXABLE INCOME (3) -S-P	MARGINAL TAX RATE
$0-10400	$0	$10400	$17075	$0	0%
10400-27325	0	27325	34000	16925	15%
27325-36675	4675	41350	43350	30950	22.5%
36675-40675	6675	47350	47350	36950	42%
40675-78575	6675	85250	85250	74850	28%

C. The Medicare Catastrophic Coverage Act of 1988: Its Effect on Marginal Tax Rates

The Medicare Catastrophic Coverage Act of 1988 limited the amount a covered individual must pay for hospital care, physician services, medical supplies, and outpatient drugs covered by Medicare. It increased home health, skilled nursing facility and hospice coverage and added breast-cancer screening and respite care benefits. The coverage was to be mandatory for all individuals eligible for Medicare A - basically everyone over age 65 - and was to be funded by a supplemental premium based on the taxable income of these individuals. The supplement premium was stated as an amount per $150. of federal tax liability.(1:52) For example, in 1989 the rate was $22.50 for each $150 of tax liability, rising to $37.50 in 1990, with scheduled annual increases thereafter. These rates really were percentage surtaxes (and will be treated as such in this paper). "The surcharge is not tax deductible, cannot be treated as an itemized medical deduction, and is considered a tax for estimated tax purposes (but not for purposes of any tax credits or the alternate minimum tax)." (1:52)

Using the examples given above, the percentage surtax for 1989 is 15% ($22.50/$150) of tax due and the surtax for 1990 is 25% ($37.50/150). The supplemental premium was subject to a maximum per individual, with the rate for a couple being twice the individual rate. Table 4 summarizes the percentage surtax and the maximum amounts to be paid in each year according to the schedule contained in the Act.

Since the supplemental premium is stated as a percentage of taxable income, it compounds with the increase in percentage rates resulting from taxation of

Table 4 - Supplemental Medicare Premium Rates, Maximum Supplemental Premiums, and Tax Liability (net of supplement) and Taxable Income Required to Reach the Maximum Premium. All information regarding supplemental rates and maximums is from "The Medicare Handbook".

	RATE/$150 OF TAX	% RATE	MAXIMUM PAYMENT	TAX LIABILITY AT MAXIMUM BEFORE SUPPLEMENT		TAXABLE INCOME TO REACH MAXIMUM
1989	$22.50	15.0%	$800	single	$5,333	$27,350
				joint	$10,666	$45,900
1990	$37.50	25.0%	$850	single	$3,400	$20,600
				joint	$6,800	$38,100
1991	$39.00	26.0%	$900	single	$3,461	$20,650
				joint	$6,922	$38,600
1992	$40.50	27.0%	$950	single	$3,518	$20,900
				joint	$7,036	$38,950
1993	$42.00	28.0%	$1,050	single	$3,750	$21,700
				joint	$7,500	$40,600

Table 5 & 6 - Effective Marginal Tax Rates for Single and Married Taxpayers, with Proposed Medicare Surcharge, 1989 Rates

Amounts in columns 2-5 apply to maximum about shown in column 1.

SINGLE TAXPAYER OVER AGE 65							
INCOME BEFORE SS (1)	TAXABLE SS RETIREMENT (2)	ADJUSTED GROSS (1) + (2)	MODIFIED ADJ GROSS (1) +8900/2	TAXABLE INCOME (1)-S-P+(2)	MARGINAL TAX RATE W/O MEDICARE	MEDICARE SUPPLEMENTAL RATE	MARGINAL TAX RATE W/MEDICARE
$0-5850	$0	$5850	$10300	$0	0%	0%	
5850-20550	0	20550	25000	14700	15.0%	15.0%	17.3%
20550-23116	1283	24399	27566	18549	22.5%	15.0%	25.9%
23116-28984	4217	33201	33434	27351	42.0%	15.0%	48.3%
28984-29450	4450	33900	33900	28050	42.0%	0%	42.0%
29450-46300	4450	50750	50750	44900	28.0%	0%	28.0%
					33.0%	0%	33.0%
MARRIED COUPLE BOTH OVER AGE 65, FILING JOINTLY							
INCOME BEFORE SS (1)	TAXABLE SS RETIREMENT (2)	ADJUSTED GROSS (1) + (2)	MODIFIED ADJ GROSS (1)+13350/2	TAXABLE INCOME (1)-S-P+(2)	MARGINAL TAX RATE W/O MEDICARE	MEDICARE SUPPLEMENTAL RATE	MARGINAL TAX RATE W/MEDICARE
$0-10400	$0	$10400	$17075	$0	0%	0%	
10400-27325	0	27,325	34000	16925	15.0%	15.0%	17.3%
27325-36675	4675	41350	43350	30950	22.5%	15.0%	25.9%
36675-40675	6675	47350	47350	36950	42.0%	15.0%	48.3%
40675-49625	6675	56300	62975	45900	28.0%	15.0%	32.2%
49625-78575	6675	85250	85250	74850	28.0%	0%	28.0%
					33.0%	0%	33.0%

social security retirement benefits. Consider the effect of an additional dollar of income for a retiree in the 28% bracket, subject to the 1990 25% supplemental premium and within the range of income in which social security is being integrated into taxable income. An additional dollar of income will convert $.50 of previously untaxed social security income to taxable income, effectively increasing the marginal tax rate by 50%, as has previously demonstrated in section B. In the situation described above, this would result in $.42 in additional tax (1 X .28 X 1.5). The $.42 in additional tax would result in a supplemental premium of $.42 X 25% = $.105, for a total increase in tax of $.525 and an effective marginal tax rate of 52.5%. The effective marginal rate can thus be derived by multiplying the table rate times the 50% effective increase from social security integration times the percentage supplemental rate. (28% X 1.5 X 1.25 = 52.5% for the above example). Tables 5 and 6 are tables 2 and 3 restated to include the effects of the supplemental premium using 1989 rates. Notice that the maximum supplemental premium is met by a single taxpayer before the taxation of social security retirement ceases, but a couple continues to pay the supplemental premium on amounts considerably above the point at which social security taxation ceases. This is due to the requirement that the supplemental premium amount be paid on each individual.

Tables 7 and 8 are tables 2 and 3 restate to include the effects of the 1990 supplemental rates. In that year rates are scheduled to increase from 15% to 25%. The individual maximum will also increase, but by a proportionately lesser amount. As a result, less income is required to reach the maximum supplemental amount, but effective marginal rates are higher until these maximums are reached than was the case in 1989.

D. Summary and Conclusions

The adverse reaction to the Medicare Catastrophic Coverage Act of 1988 stems from the method of funding the benefits provided in the Act. As this paper has demonstrated, the effect of the supplemental tax provided for in this Act has been to increase marginal tax rates for some groups of elderly taxpayers. The taxation of social security benefits interacts with the supplemental tax to produce some of the highest marginal personal tax rates presently in effect. Based on the increases scheduled for 1990 and beyond, these rates would reach amounts in excess of 50%. The supplemental amounts to be paid by individuals subject to this additional tax would be in excess of expected benefits for these individuals because the supplemental tax must also fund benefits for the 40-50% of those individuals who are over age 65 and who do not contribute to this program because they have no taxable income.(3:24) The tax was thus based on the questionable premise that the wealthier individuals in a particular age group should be taxed to provide benefits for other members of that age group rather than funding benefits for low income individuals from general tax revenues.(2:45) The correction of this inequity would appear to be part of any solution to finding an acceptable means of funding catastrophic health care coverage for all individuals.

E. Suggestions for Future Research

The failure of the Medicare Coverage Act of 1988 appears to be due the failure of the authors of that Act to consider the interaction of their proposal with the existing tax structure which applies to retirees. Additional research is required to develop alternative methods of funding programs such as the one proposed here which do not compound with the existing tax structure. Such a system might include a reevaluation of the present method of integration of social security income into taxable income, thus avoiding the present problem of compounding of tax rates due to social security integration.

A more basic question for future research is the extent to which narrowly-targeted programs aimed at relatively small subgroups within the population are a valid approach for future healthcare legislation or whether this entire problem should be consolidated into a more comprehensive national healthcare program. ❧

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Table 7 & 8 - Effective Marginal Tax Rates for Single and Married Taxpayer, with Proposed Medicare Surcharge, 1990 Rates

Amounts in columns 2-5 apply to maximum amount shown in column 1.

SINGLE TAXPAYER OVER AGE 65

INCOME BEFORE SS (1)	TAXABLE SS RETIREMENT (2)	ADJUSTED GROSS (1) + (2)	MODIFIED ADJ GROSS (1) +8900/2	TAXABLE INCOME (1)-S-P+(2)	MARGINAL TAX RATE W/O MEDICARE	MEDICARE SUPPLEMENTAL RATE	MARGINAL TAX RATE W/MEDICARE
$0-5850	$0	$5850	$10300	$0	0%	0%	
5850-20550	0	20550	25000	14700	15.0%	25.0%	18.8%
20550-23116	1283	24399	27566	18549	22.5%	25.0%	28.1%
23116-24484	1967	26451	28934	20601	42.0%	25.0%	52.5%
24484-29450	4450	33900	33900	28050	42.0%	0%	42.0%
29450-46300	4450	50750	50750	44900	28.0%	0%	28.0%
					33.0%	0%	33.0%

MARRIED COUPLE BOTH OVER AGE 65, FILING JOINTLY

INCOME BEFORE SS (1)	TAXABLE SS RETIREMENT (2)	ADJUSTED GROSS (1) + (2)	MODIFIED ADJ GROSS (1)+13350/2	TAXABLE INCOME (1)-S-P+(2)	MARGINAL TAX RATE W/O MEDICARE	MEDICARE SUPPLEMENTAL RATE	MARGINAL TAX RATE W/MEDICARE
$0-10400	$0	$10400	$17075	$0	0%	0%	
10400-27325	0	27,325	34000	16925	15.0%	25.0%	18.8%
27325-36675	4675	41350	43350	30950	22.5%	25.0%	28.1%
36675-40675	6675	47350	47350	36950	42.0%	25.0%	52.5%
40675-41825	6675	48500	55175	38100	28.0%	25.0%	35.0%
41825-78575	6675	85250	85250	74850	28.0%	0%	28.0%
					33.0%	0%	33.0%