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THE COST OF NO MEDICARE REFORM: WHAT INDUSTRY AND GOVERNMENT WOULD PASS ON TO CONSUMERS, INVESTORS, TAXPAYERS, AND WORKERS

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If an unreformed Medicare program is to be able to pay the hospital bills of today's workers when they reach retirement, industry and government will have to pass on additional yearly costs of at least \$7.4 billion to investors and consumers. In addition, workers will face additional annual costs of at least \$115.7 billion in direct taxes and reduced wages. These costs will be the result of the additional payroll taxes, on top of current payroll taxes, needed to assure long-term fiscal solvency of the cash-strapped Medicare hospitalization trust fund if no reforms are enacted. The reason the burden is so heavy on employees is that an increase in payroll taxes technically is shared by both the employer and the employee. Experience indicates that about 88 percent of the cost of additional employer taxes is passed on to workers in the form of reduced wages and compensation.¹ Moreover, the cost of stabilizing the hospital trust fund is only part of the necessary burden if reforms are not implemented. To cover the rising costs of Part B, which covers physicians' costs, Congress would have to raise taxes even further.

The current financial status of Medicare is precarious. Without significant structural reform of the system or increases in the current payroll tax to maintain the level of benefits and spending, Medicare will go bankrupt. For Medicare to remain financially solvent and legally able to pay for hospital care for today's "baby boomers" when they retire, Congress needs either to find additional money for the hospital trust fund or to slow down its rate of spending.

Trustees' Tax Options. The seven members of Medicare's Board of Trustees have determined that the Medicare Hospitalization (HI, or Part A) Trust Fund that finances hospital services for the elderly will be insolvent by 2002. In addressing the tax question, the trustees have outlined three possible options to solve the financing problem if no structural reforms are enacted: a short-term option of an immediate 1.3 percent additional payroll tax, needed to keep the hospital program solvent for 25 years; an intermediate option of a 3.52 percent payroll tax, needed now to

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1 The 88 percent is based on such analyses as Jonathan Gruber and Alan B. Krueger, "The Incidence of Mandated Employer-Provided Insurance: Lessons from Workers Compensation Insurance," *Tax Policy and Economy* (1991); Jonathan Gruber, "The Incidence of Mandated Maternity Benefits," *American Economic Review* Vol. 84 (June 1994); and Lawrence H. Summers, "Some Simple Economics of Mandated Benefits," *American Economic Review*, Vol. 79, No. 2 (May 1989).

make the hospital program permanently solvent; and a high-cost option of a 3.9 percent payroll tax, needed if no action is taken until the actual depletion of the Medicare trust fund in seven years.² For purposes of econometric analysis, the authors of this study used the trustees' intermediate option of a 3.52 percent payroll tax, under which Congress, rather than adopt structural changes in the program, would keep Medicare basically the same and finance the same level of benefits and projected costs through tax increases. Under this scenario, the trust fund would be able to pay for hospital care for the foreseeable future, not just for the next 25 years.

- ✓ **Under this option, an additional tax of 3.52 percent of taxable payroll would be "shared" between employers and employees.** According to earnings data by industry taken from the March 1994 *Current Population Survey*, the total yearly cost of this additional HI payroll tax would have been \$123 billion, or about two percent of Gross Domestic Product, had such a tax gone into effect in 1993. On average, using an 88 percent "pass through," and had the tax increase been in effect in 1993, the combined direct tax and indirect wage loss to employees would have been about \$862 per employee, for a total cost to employees of \$115.7 billion (out of the \$123 billion).³
- ✓ **The amount of new tax not paid directly by employees or indirectly passed through to them would take the form of additional costs to customers and investors.** The analysis delineates the impact by industry of a 3.52 percent increase in the HI payroll tax. Overall, using the 88 percent "pass through" effect on employee wages and compensation, and had the tax been in effect in 1993, industry would have \$7.4 billion to pass on to consumers and investors, rather than to employees. If the tax were imposed now, that number could be much larger because of the growth in earnings since 1993.
- ✓ **Retail trade, educational services, and public administration would be the hardest hit by such a tax, together shouldering nearly \$15 billion, or 25 percent of the cost of the additional tax before passing it on to employees, customers, and investors.** The retail trade industry alone will have to pass at least \$800 million on to customers and investors, with educational services and public administration passing on \$542 million and \$487 million, respectively.
- ✓ **Unlike the private sector, public-sector employers do not have the luxury of passing on costs such as additional Medicare payroll taxes to customers and investors.** Taxes must be increased or programs cut to pay for whatever costs are not passed on to employees in the form of reduced wages and compensation. Moreover, taxpayers potentially could fund a larger share of the burden of the additional payroll tax than customers and investors in the private sector since government pay scales and contracts could restrict their ability to pass on additional costs to employees.

2 For a discussion of the trustees' tax options, see Stuart M. Butler, "The High Cost of Not Reforming Medicare," *Heritage Foundation F.Y.I.* No. 56, May 4, 1995.

3 See Robert E. Moffit, John C. Liu, and David H. Winston, "What Americans Will Pay If Congress Fails to Reform Medicare: The State and Congressional District Impact," *Heritage Foundation F.Y.I.* No. 62, September 19, 1995.

APPENDIX

COST CALCULATION ASSUMPTIONS

Cost of HI Tax by Standard Industrial Classification Code

The national aggregate of employee earnings by industry was derived from the March 1994 *Current Population Survey*. These earnings are for 1993. The cost calculations assume the payroll tax increase had been in effect that year; the normal growth in earnings means that the payroll tax and its associated costs would be higher in 1996 and subsequent years.

Due to the nature of self-reported income surveys, the CPS generally underestimates earnings. In order to develop a multiplier to adjust the CPS-reported earnings, we compared the CPS total with the national employee and proprietor earnings reported in the *Statistical Abstract of the United States* table on national income in 1993 (as determined by the U.S. Bureau of Economic Analysis, *Survey of Current Business*, April 1994).

After April 1986, all state and local employees were required to pay Medicare taxes. In 1991, however, the law was amended to allow those hired before that date to opt out. The Congressional Research Service has estimated that as of March 1994, 1.7 million workers were not covered by Medicare. Using the 1.7 million figure, we removed the exempt workers and their earnings from each industry class based on the distribution of state and local government employees in each category according to the 1994 *Current Population Survey*.

Based on a survey of economic literature estimating the "pass-through" wage effect of employer mandates by health care econometrics firm Lewin-VHI, we assumed 88 percent of the cost of the additional tax to be passed on to employees in reduced compensation. We also assumed that the pass-through had fully occurred. Therefore, we assumed the total cost of the additional Medicare tax to employees to be 88 percent of the business's share of the Medicare tax (about 1.56 percent) in addition to the 1.76 percent tax on wages paid directly by the employee.

The cost of the HI tax to customers, investors, and taxpayers is the remaining 12 percent not passed through to employees.

Note on "Children." The *Current Population Survey* classifies all wage earners under the age of 15 as "children." Because these workers, who include such individuals as young farm workers, are not officially considered part of the labor force, the CPS does not collect specific industry information on these wage earners. The CPS, however, does not collect income data for wage earners under 15, and so in reality the wages identified by CPS for "children" category are the results of miscoding by CPS and actually accrue to wage earners aged 15 and above. These miscoded wage earners and their employers do pay the HI payroll tax on reported income. Thus they are included in this analysis under the separate, non-industry-specific category of "children" used by the CPS.

Table 1

Cost of No Reform: The Impact of an Additional 3.52% Medicare Payroll Tax By Industry, Data from 1993

Standard Industrial Classification	Industry	Total of Extra Payroll Taxes Paid by Business and Employee	Extra Payroll Taxes Paid Directly by Business	Total Extra Cost to Employees= Direct Tax + 88% Pass Through	Cost to Consumers and Investors
031-032	Forestry and Fisheries	\$223,446,000	\$111,723,000	\$210,039,000	\$13,407,000
035, 063	Agriculture	\$1,917,794,000	\$958,897,000	\$1,802,726,000	\$115,068,000
040-050	Mining	\$1,102,890,000	\$551,445,000	\$1,036,717,000	\$66,173,000
060	Construction	\$7,259,524,000	\$3,629,762,000	\$6,823,953,000	\$435,571,000
100-122	Food and like Items	\$1,735,374,000	\$867,687,000	\$1,631,252,000	\$104,122,000
130	Tobacco	\$79,870,000	\$39,935,000	\$75,078,000	\$4,792,000
132-150	Textile Mill	\$568,352,000	\$284,176,000	\$534,251,000	\$34,101,000
151-152	Apparel and Finished Textile	\$747,784,000	\$373,892,000	\$702,917,000	\$44,867,000
160-162	Paper and Allied Products	\$830,222,000	\$415,111,000	\$780,409,000	\$49,813,000
171-172	Printing, Publishing, and Allied Industry	\$2,026,548,000	\$1,013,274,000	\$1,904,955,000	\$121,593,000
180-192	Chemicals and Allied Products	\$2,048,520,000	\$1,024,260,000	\$1,925,609,000	\$122,911,000
200-201	Petroleum and Coal Products	\$263,038,000	\$131,519,000	\$247,256,000	\$15,782,000
210-212	Rubber and Miscellaneous Plastics Products	\$716,952,000	\$358,476,000	\$673,935,000	\$43,017,000
220-222	Leather and Leather Products	\$163,106,000	\$81,553,000	\$153,320,000	\$9,786,000
230-241	Lumber and Wood Products	\$584,510,000	\$292,255,000	\$549,439,000	\$35,071,000
242	Furniture and Fixtures	\$614,542,000	\$307,271,000	\$577,669,000	\$36,873,000
250-262	Stone, Glass, Clay, and Concrete Products	\$675,364,000	\$337,682,000	\$634,842,000	\$40,522,000
270-280, 301	Primary and Not Specified Metals	\$1,015,702,000	\$507,851,000	\$954,760,000	\$60,942,000
281-300	Fabricated Metals	\$1,494,342,000	\$747,171,000	\$1,404,681,000	\$89,661,000
310-332	Machinery, Not Including Electrical	\$3,216,416,000	\$1,608,208,000	\$3,023,431,000	\$192,985,000
340-350	Electrical Machinery, Equipment and Supplies	\$2,408,992,000	\$1,204,496,000	\$2,264,452,000	\$144,540,000
351	Motor Vehicles and Equipment	\$1,696,882,000	\$848,441,000	\$1,595,069,000	\$101,813,000
352	Aircraft and Parts	\$760,774,000	\$380,387,000	\$715,128,000	\$45,646,000
360-370	Other Transportation Equipment	\$1,072,302,000	\$536,151,000	\$1,007,964,000	\$64,338,000
371-382	Professional and Photoequipment, Watches	\$961,718,000	\$480,859,000	\$904,015,000	\$57,703,000
390	Toys, Amusements and Sporting Goods	\$156,378,000	\$78,189,000	\$146,995,000	\$9,383,000
391-392	Misc. Manufacturing and Not Specified Industry	\$409,420,000	\$204,710,000	\$384,855,000	\$24,565,000
400-432	Transportation	\$6,359,174,000	\$3,179,587,000	\$5,977,624,000	\$381,550,000
440-442	Communication	\$2,233,560,000	\$1,116,780,000	\$2,099,546,000	\$134,014,000
450-472	Utilities and Sanitary Services	\$2,267,000,000	\$1,133,500,000	\$2,130,980,000	\$136,020,000
500-571	Wholesale Trade	\$5,439,232,000	\$2,719,616,000	\$5,112,878,000	\$326,354,000
580-691	Retail Trade	\$13,334,470,000	\$6,667,235,000	\$12,534,402,000	\$800,068,000
700-710	Banking and Other Finance	\$4,571,946,000	\$2,285,973,000	\$4,297,629,000	\$274,317,000
711-712	Insurance and Real Estate Service	\$5,507,002,000	\$2,753,501,000	\$5,176,582,000	\$330,420,000
721-750	Business Services	\$5,047,534,000	\$2,523,767,000	\$4,744,682,000	\$302,852,000
751-760	Repair Services	\$1,527,970,000	\$763,985,000	\$1,436,292,000	\$91,678,000
761	Private Household	\$258,510,000	\$129,255,000	\$242,999,000	\$15,511,000
762-791	Personal Services, Except Private Household	\$2,233,962,000	\$1,116,981,000	\$2,099,924,000	\$134,038,000
800-810	Entertainment and Recreation Services	\$1,556,916,000	\$778,458,000	\$1,463,501,000	\$93,415,000
812-830, 832-840	Health Services, Not Hospitals	\$5,766,310,000	\$2,883,155,000	\$5,420,331,000	\$345,979,000
831	Hospitals	\$5,854,648,000	\$2,927,324,000	\$5,503,369,000	\$351,279,000
841, 872-893	Other Professional Services	\$7,468,608,000	\$3,734,304,000	\$7,020,492,000	\$448,116,000
842-860	Educational Services	\$9,024,754,000	\$4,512,377,000	\$8,483,269,000	\$541,485,000
861-871	Social Services	\$1,709,950,000	\$854,975,000	\$1,607,353,000	\$102,597,000
900-932	Public Administration	\$8,119,558,000	\$4,059,779,000	\$7,632,385,000	\$487,173,000
	Children	\$1,560,000	\$780,000	\$1,466,000	\$94,000
	Total	\$123,033,430,000	\$61,516,715,000	\$115,651,424,000	\$7,382,006,000

Source: The Heritage Foundation Medicare Cost Projection Model.

