



L. R. Levin Consulting, L.L.C.

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Special Edition On Healthcare

Will Healthcare Costs Imperil the Recovery?

For the past year, the country has debated healthcare legislation. Real healthcare reform should have three principal components 1) deliver healthcare services and products more efficiently and effectively, 2) make health insurance more available and affordable through appropriate risk sharing and 3) reduce the excessive punitive damage awards whose costs are passed on to healthcare consumers.

Such legislation would improve the efficiency and quality of our healthcare system and could materially help the economy. *Does the new legislation contain these elements?*

The new healthcare legislation does not appear to have many, if any, of those elements. There is nothing we have found in the legislation that will be a positive for the economy in 2010 or 2011.

In our October 2009 [Look Back Issue](#), we suggested there were five “Dark Clouds on the Horizon,” one of which was the pending healthcare reform bill. We pointed out that it “contains substantial new taxes and inflationary provisions.” As passed, the new healthcare law contains **12 new federal taxes** aggregating more than \$569 Billion Dollars in tax increases.

The problem with tax increases is that they siphon liquidity from the economy. If enough liquidity is removed at a time when the economy is weak, it could adversely affect the recovery. On the plus side, the tax in-

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creases in the healthcare legislation are complex and roll in over a long period of time.

Perhaps the most highly visible immediate tax increase is the elimination of the deduction for the federal subsidies to companies providing prescription coverage for retirees. The “popular press” have focused on “should the big corporations continue to receive this unusual tax break.”

Does ending the deductibility of the federal subsidy save the government money? Let us explain what this is really about, since this last minute tax increase may be an example of the unintended consequences often contained in rush legislation. When the government adopted the Medicare program covering drugs for Medicare recipients, it was estimated that it would cost the government about \$12,000 per Medicare recipient to add drug coverage.

There were a substantial number of Medicare recipients that were already receiving drug benefits under their retirement programs from large companies. If these companies ended their drug programs and those Medicare recipients adopted the new Medi-

care program, it would place an enormous added cost on Medicare.

The private sector programs provided essentially the same coverage as Medicare for approximately one half the government’s cost or approximately \$6,000 per recipient. Clearly it would be highly beneficial for the government, if these companies retained their drug benefits.

So the government undertook to pay these companies about \$6,000 per recipient to retain their coverage, thus saving the government \$6,000 per recipient while at the same time saving the companies \$6,000 – a win for both the public and private sector.

The government, in order to minimize its cost, gave a subsidy which was deductible to the companies and therefore, exempted from income tax. Thus, the subsidy only had to be enough that when added to the tax saving (of deducting it from the companies income) equaled the companies approximate \$6,000 cost.

When searching for ways to raise taxes, the healthcare bill drafters found the tax deduction and decided to eliminate it without thinking about why it had been enacted in the first place. By eliminating the deduction,

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the healthcare legislation increases the cost to these companies of providing retiree drug benefits. This means that the companies will be financially better off if the companies end this retiree coverage. If they do, the governments cost for the drug coverage will increase from \$6,000 to \$12,000 for each Medicare recipient that goes off the private plan and onto the Medicare drug program.

Politically the spin looks like the government stopped “big, bad” companies from obtaining unfair tax breaks and lowered the cost of the healthcare legislation. But in reality, it increased the cost of the Medicare drug program to taxpayers by more than it saved!

The first impact will be over the next several years as private coverage ends, siphoning liquidity out of the economy, and increases the deficit as the government is forced to pay more of the cost of drug benefits. As is now clear, the cost will be in the billions.

The healthcare law also creates more than 150 new federal agencies and should, over time, provide 32 million more people health insurance (16 million under Medicaid). For some,

the question is will this new healthcare entitlement create such a large deficit that it will destroy the country’s solvency? That is a question that will not be fully answered for several years.

The more immediate business question is, will the \$569 Billion Dollars in new taxes imperil the recovery or push us into another deeper recession? If we are only talking about the next 6 to 8 months the answer should be **no**. The slowly stabilizing economy is still on track in 2010 to give us slightly improved numbers compared to the bottom. Lead by manufacturing, the economy should continue to improve in 2010.

With an eye strongly focused on the elections this November, the Congress was careful to delay most tax increases until after this year, perhaps even after the 2012 Presidential election. We said the tax provisions were complex because, among other things, they phase in over several years. Beginning in 2011 along with the expiration of the “Bush tax cuts,” taxes continue to increase each year through 2018.

What are the new taxes and when do they start? Along with the

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elimination of the deduction just discussed, the first meaningful new taxes are on drug makers and medical device manufacturers. These two taxes come on line beginning in 2011 through 2013.

These device and drug taxes represent approximately \$23 Billion dollars and when coupled with reductions in personal health accounts deductions, represent substantial tax increases in 2011.

This means that if the economy is not strong by the end of this year that substantial liquidity will be removed by these new taxes beginning in 2011. Each year until 2018 the reduction in liquidity and purchasing power will increase as more health-care taxes come on line.

The House both added taxes and altered those taxes the Senate Bill had imposed.

For example, the House bill, in order to secure the forecast it desired from the Congressional Budget Office (CBO), added its own special twist to the Medicare tax. The Senate had increased the Medicare tax on people earning *wages* of over \$200,000 (\$250,000 on joint filers) from 2.9% to 3.8%, a 0.9% increase with no cap.

The House added an entirely new twist. In addition to *wages*, the House broadened the tax to include *investment income*! Thus, individuals who report more than \$200,000 (\$250,000 on joint filers) will pay the tax on all income above that amount whether it is from wages or investments.

The House concept is very broad. It includes interest, dividends, annuities, royalties and rents (e.g., interest and dividends on bonds and stock), gains from the sale of stocks, bonds and real estate, (including homes) and passive partnership or passive LLC business income. Essentially the only income not included is distributions from tax-qualified retirement plans.

The good news is the tax does not go into effect until the start of 2013. For that reason during the period 2010 to 2012 this tax won't take liquidity out of the economy.

This tax, when it starts, will directly drain purchasing power from consumers, since it will be paid 100% by individuals, including the self-employed. None of these Medicare taxes will be paid by employers. For "pass through entities" this raises in-

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interesting questions of how to protect passive investors without losing liquidity that is needed to create jobs and maintain growth since, absent the company passing funds to passive owners, they will be taxed on phantom income they don't receive.

Because some state's income tax laws do not dovetail with the federal tax laws what distributions are state law dividends creates enormous complexity for pass through entities.

All of this will be left to thousands of pages of federal regulations and future state tax changes to sort out how the difference in tax between those who are "active" participants and "passive" participants in these enterprises will be affected. It is safe to say that none of the members of congress that voted on the investment Medicare tax understood or even knew how all of this will work.

For 2011 the Bush tax cuts will have expired and the maximum tax bracket will rise to 39.6% (from the current 35%). Also, the capital gains and dividends tax will increase to 20% (from the current 15%). When the new Medicare tax is added in 2013, the ordinary income rate will increase to 43.4% and the capital

gains and dividends tax will increase to 23.8%.

By 2018, the tax on higher cost health plans will begin. With inflation and the increased cost of medical services and premiums caused by the new law, this may hit many more healthcare insurance plans than people realize.

Most estimates indicate that the tax on medical devices, medical insurance providers, and cuts in Medicaid that will be passed on to those who have insurance, all will result in substantial increases in premium and healthcare costs. This will also withdraw increasing amounts of disposable income from consumers during this period.

It is too early to tell what the economic impact will be of the taxes and penalties related to obtaining health insurance. The tax on companies that do or don't provide health insurance may hit smaller companies disproportionately. The CBO assumed that the tax for companies that do not provide health insurance, will be less than the cost of providing insurance.

Based on this, it was assumed that many companies that currently

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provide insurance will stop providing it and that will cause people to seek insurance from the new exchanges. If this occurs it will increase tax revenues. But it may also drive up premiums and healthcare costs. Dropped from employer insurance, many may not obtain new insurance.

The final legislation lowered the penalty for not having insurance. It also provided that individuals could obtain insurance after the occurrence of problems that would make health insurance important going forward. This combination means that for individuals it may be cheaper to pay the penalty and forego insurance until a problem occurs.

If this is the practical effect of the legislation, then all of the risk spreading and cost of the healthcare concepts envisioned in the legislation will prove false. Under that scenario, insurance premiums and the cost of the program to taxpayers will increase materially. This could have a dramatic affect on the deficit and require material increases in taxes.

For all of these reasons, economists are beginning to have concerns about the negative impact of this legislation on the economy and the defi-

cit after 2010. To achieve their numbers from the CBO, Congress included such gimmicks as collecting \$8 billion in excess tax deposits in 2014 that will need to be refunded in 2015. Many economist think to cover the actual deficits caused by the Healthcare bill will require a substantial new value added tax on everything we buy.

Such a tax could have a meaningful negative impact on the economy. Another major source of pressure to increase taxes is the 16 million new Medicaid patients created by the healthcare law. To the extent the Federal government covers this added cost, it will materially add to the deficit. As that cost is increasingly shifted to the states, it will require substantial new state taxes to pay for this new entitlement.

This will put enormous pressure on the states to increase state taxes to pay for this unfunded mandate. One need only look at Massachusetts and California's experience to see how these new unfunded mandates may affect the states.

In summary, the substantial tax increases required by this law begin to impact in 2011, and absent dramatic

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growth in the economy will reduce non-government employment and negatively affect economic activity in the years after 2010.

It is very important for businesses to start looking at how all of these substantial changes will affect their operations going forward. Only through careful planning now can the adjustments needed to fund business operations and shareholders needs going forward be in place as 2011 and beyond arrive.

All forms of financing, whether banking lines of credit, commercial paper, floor planning, consumer credit, or other, will be affected. There is no question that beyond 2010 this will increasingly affect the economy in a direct way. For the next 6 to 18 months the effect will be more indirect.

ployment, “cap and trade,” healthcare “reform,” and value added taxes.” Because healthcare was delayed and many of the tax provisions moved until after 2010, it should have little direct impact during the next 6 to 8 months.

The economy has benefited since October from the failure of any of the other dark clouds to materialize. But just as Scott Brown’s election at first appeared to signal that the Healthcare bill was off the horizon, it may well be premature to report the passing of the other 4 thunderstorms.

The Euro Zone financial crises in Greece, Ireland, Spain and Portugal have caused the dollar to retain strength as a safe haven, delaying the potential early 2010 meltdown. As the U.S. economy has stabilized and the deficit materially increased this is changing.

Even with 162,000 new jobs, long term structural unemployment continues to impede real recovery. The consensus economists predict a return to normal unemployment levels no sooner than 2016! A new push for “cap and trade” is in the wind. Even more frightening, the very understatement of the cost of healthcare reform is now being cited as why we need a value added tax to be enacted.

Let us hope these storms blow over and 2010 sees continuing forecasts of better weather. As they said in *Gone with the Wind* – tomorrow may be a better day.



What of the Remaining 4 Dark Clouds?

In our October Look Back Issue we said “to name a few, there are five major negative factors that loom large in how 2010 may develop. These include the value of the dollar, unem-

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