National Bureau of Economic Research

RETIREMENT RESEARCH CENTER
SEPTEMBER 2012

Means-Testing Federal Health Entitlement Benefits

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In recent years, federal legislation has linked the price paid for health insurance benefits to measures of current income. Under the Patient Protection and Affordable Care Act of 2010 (ACA), individuals and families with income as high as 400% of the federal poverty level are eligible for subsidies that limit their health insurance premiums to no more than 9.5% of their income. Under the Medicare Modernization Act of 2003 (MMA), higher-income beneficiaries face income-related premiums over three times the standard premium for Part B coverage.

In both of these examples, policymakers have chosen to implement means-testing by linking individual premiums to measures of current income. There are several concerns about current income as a measure of ability to pay that are overcome by the use of lifetime earnings. First, lifetime income can be a more accurate measure of each person's ability to pay than is income in a single year. Since income may be temporarily high or low in a given year, a better measure of ability to pay can be obtained by averaging several years of income. Second, lifetime income is based on past labor income rather than current investment earnings and is therefore less susceptible to manipulation. Third, the use of lifetime income avoids penalizing people who save during their working years. A tax on asset income during retirement is analogous to a tax on saving before retirement. Fourth, the imposition of higher premiums for higher current income penalizes those who continue to work, either after they become eligible for Medicare in the case of the MMA or before they are eligible for Medicare in the case of the ACA.

This paper considers an alternative measure of "ability to pay" in the form of average lifetime earnings derived from Social Security and Medicare earnings histories as a means of determining eligibility for premium subsidies under ACA or income-related premiums under the MMA. Just as Social Security benefits are based on a measure of Average Indexed Monthly Earnings (AIME), eligibility for premium subsidies or requirements to pay supplementary Medicare premiums could be based on an analogous concept of lifetime earnings subject to Medicare tax, described in the study as "Medicare Average Earnings," or MAE. The analysis in this paper compares the impact of means-testing on current income to means-testing on lifetime income using the version of the Health and Retirement Study (HRS) that is linked to Social Security earnings records.

The main result of the Medicare analysis is that in general, based on reported household income, there is considerable time-series variation in the level of the income-related Medicare premium for those who pay it. More importantly, there is little systematic difference in lifetime income across the households who pay very different income-related premiums each year. The income-related premium for Medicare Parts B and D can be expected to function very much like a tax on capital.

The analysis of means-testing in the ACA focuses on individuals age 50 – 62 who are nearing retirement but not eligible for Medicare. For those who are uninsured, nearly 75 percent have incomes low enough to qualify for a premium subsidy. As with the MMA, there is considerable time-series variation in the premium subsidy, due to fluctuations in reported annual income. This variation is largely eliminated by using MAE as the basis for means-testing. For example, for individuals working in consecutive surveys, median changes in MAE are only 3.1 percent, with 90 percent of changes less than 11 percentage points over the two years. Further, preliminary tabulations indicate that for workers who have employer-based health insurance as employees but not retirees and who have household income above 400 percent of the Federal Poverty Level while working, up to 60 percent – approximately 3.2 million workers per year – would qualify for a premium subsidy if they retired.

Overall, our findings suggest that a measure of lifetime income compares favorably to current income as a basis for means-testing. It offers less short-term variation in premiums while improving incentives for pre-retirement work and saving.

The full working paper is available on our website, www.nber.org/programs/ag/rrc/books&papers.html, as paper NB12-16.

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This research was supported by the U.S. Social Security Administration through grant #RRC08098400-04-00 to the National Bureau of Economic Research as part of the SSA Retirement Research Consortium. The findings and conclusions expressed are solely those of the author(s) and do not represent the views of SSA, any agency of the Federal Government, or the NBER.