WORKING PAPER
Executive Summary

NOVEMBER 2006, WP# 2006-20

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

HEALTH CARE COSTS, TAXES, AND THE RETIREMENT DECISION: CONCEPTUAL ISSUES AND ILLUSTRATIVE SIMULATIONS

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Soaring health costs are imposing enormous pressures on public budgets. Absent radical reforms in health policy, those pressures will grow rapidly in the future. At the Federal level, common projections imply that Medicare and Medicaid outlays alone will absorb an additional 4 to 7 percentage points of the GDP in 2030 than they do today. At the state level, Medicaid is already putting a squeeze on other functions of government.

Government may be spending more, but not because it is reducing the burden on private individuals. Quite the contrary, private individuals also face large and growing health care costs. Despite near-universal Medicare coverage, these costs can be particularly burdensome for older Americans, who face out-of-pocket expenses for Medicare premiums, private supplemental premiums, and direct payments to health care providers for deductibles and copayments. Additionally, increasing public costs are likely to boost future tax burdens. Some of this increase will probably fall on older Americans, subjecting them to a double whammy.

This study considers how rising tax burdens and out-of-pocket health care costs will affect the timing of retirement. The paper explores conceptual issues and computes an upper bound on the likely effects.

Conceptually, the impact of taxes depends on which particular taxes are raised. Increased tax burdens on Social Security, pension, and other investment income are likely to delay partial and complete retirement. The effects of wage, income, and consumption tax increases are theoretically ambiguous. However, any move toward consumption taxation would be particularly burdensome on older individuals who are drawing down capital assets to finance consumption.

The most important driver of health costs is likely the continual flow of new goods and services into the marketplace, propelled by technological change. These innovations allow people to buy valuable goods and services not previously available. For example, only recently were people able to buy enhanced mobility with joint replacements, better eyesight through laser surgery, or lower cholesterol with statins. People will likely spend more on medical goods and services as new products become available, thus demanding fewer non-health goods and less leisure time. However, this conclusion is not a theoretical necessity. New non-health goods are also coming on to the market, and people are continually finding new ways to use leisure time. Also, some of the new health products may be complementary to leisure.

How well people anticipate future increases in taxes and health care costs, and how they react at younger ages, will crucially affect retirement impacts. If households are farseeing rational planners, higher health costs and tax burdens will likely induce more saving and harder work while young, muting effects on retirement decisions. If households wait until the burden is upon them before they react, delaying retirement is likely to become a much larger part of the adjustment.

To gauge the potential importance of rising taxes and health care costs to the retirement decision, the study compares projected retirement income for prototypical workers under two sets of assumptions about future tax and health care burdens. The high-cost scenario assumes that health care costs grow at the rapid rate projected by the Medicare trustees and that effective tax rates rise dramatically as Congress allows the 2001-2003 tax cuts to expire and does nothing to restrain tax-bracket creep, the growth of the Alternative Minimum Tax, or the increase in the share of households with taxable Social Security benefits. The low-cost scenario assumes that tax burdens remain at their approximate 2000 levels and that health care costs remain constant in real terms between 2000 and 2030. The analysis then estimates how much longer representative adults would have to work under the high-cost scenario to receive as much income in the first year of retirement — net of taxes and out-of-pocket health care spending — as they would receive under the low-cost scenario.

Of course, people would probably choose to sacrifice some consumption of other goods and services when taxes and health care costs rise, instead of foregoing only leisure, and if they are farseeing they would adjust saving and work effort during their working lives, so these estimates are necessarily upper limits on the impact. Examining the impact in 2030 also exaggerates the effect on the retirement decision, since it has already been argued that it is highly unlikely that the current system can last that long.

The results show that a moderate-income couple would have to delay retirement by about 2.5 years to receive as much annual retirement income under the high-cost scenario as under the low-cost scenario. The low-income couple would have to work an additional 2.4 years to offset income lost from higher taxes and health care costs, and the high-income couple would have to work an additional 2.8 years.

Results are similar for single adults, except that low-income single adults are not affected much by the high-cost scenario. Like low-income married couples, they would not pay federal income taxes under either scenario. And they would not be affected much by rising health care costs, because most of their costs are covered by Medicaid. (The low-earning married couple receives too much income for Medicaid protection.) As a result, the low-income single adult would only have to work about six more months under the high-cost scenario than the low-cost scenario. The moderate-income single adult would have to work an additional 2.0 years, and the high-income single adult would need to work an additional 2.6 years.

 The research reported herein was performed pursuant to a grant from the U.S. Social Security Administration (SSA) funded as part of the Retirement Research Consortium (RRC). The findings and conclusions expressed are solely those of the authors and do not represent the views of SSA, any agency of the Federal Government, the RRC, the Urban Institute, or Boston College.

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