Policy Brief

South Carolina Policy Council
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Push Back:
State Tax Reform Can Ease the Pain of the Federal Health Care Takeover

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The Patient Protection and Affordable Care Act (PPACA), more popularly known as "Obamacare," is expected to cost trillions and increase the national debt by hundreds of billions of dollars. All in all, taxpayers are looking at $669 billion in new taxes over the next 10 years to pay for the new federal health care mandate.[1] This is in addition to billions of dollars in regulatory fines and fees.

According to a September 2010 Rasmussen poll, 61 percent of likely U.S. voters at least somewhat favor repealing the national health care law. As recently as January 2011, this figure was 53 percent. The U.S. House of Representatives has also voted to repeal the federal health care takeover while the U.S. Senate is considering similar legislation.

With many of PPACA's provisions beginning to take effect, including mandates that have caused insurance rates to spike by as much as 20 percent in some areas, small business owners are starting to feel the burden of heavy compliance costs associated with the new mandate. As reported by *The State*, unemployment remains high in South Carolina, in part, because businesses are "reluctant to add workers because of concerns about health care and tax costs."

And while state legislators have limited control over whether the federal health care takeover is ultimately repealed and/or blocked by the courts, they can proactively begin to address the taxation and compliance costs imposed by the Patient Protection and Affordable Care Act. At a minimum, the General Assembly can help counteract the fiscal impact of PPACA by providing for a proportionate reduction in taxation and compliance costs for South Carolina businesses.

5 Ways the Federal Health Care Takeover Is Hurting S.C. Businesses

Even apart from the constitutional issues raised by the new federal mandate, PPACA is already negatively impacting South Carolina's small businesses and taxpayers. Here are five ways the federal health care takeover is increasing business costs and discouraging new job creation.

1. New Taxes. As indicated in this list, PPACA imposes at least nine new taxes that will increase tax burdens and health care costs by billions of dollars for American employers and consumers.[2]

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[1]Michael Tanner, *Bad Medicine*, Washington, D.C.: The Cato Institute (2010), Exec. Summary.
[2]A new report by The Heritage Foundation lists 18 new taxes at a cost of $503 billion over 10 years.

One of these taxes (on tanning services) is already in place; another (on HSAs) went into effect January 1, 2011.

2. New Hidden Taxes and Fines/Fees. Small businesses (those with less than 50 employees) are currently exempt from the employer mandate scheduled to go into effect in 2014. The mandate requires larger employers to offer every employee "minimum essential coverage," as defined by the Secretary of Health & Human Services. The fine for not doing so is $2,000 per full-time employee. The Congressional Budget Office estimates this new mandate will cost businesses $52 billion over 5 years, beginning in 2014. In addition, employers must offer "affordable" coverage, or be fined $3,000 per employee whose coverage is deemed "unaffordable" – that is, more than 8 percent of an employee's income. These penalties are expected to hit as many as one-third of employers. In effect, these fines are hidden taxes imposed in an arbitrary and nontransparent manner.

3. Higher Premiums. According to the U.S. Department of Health & Human Services, more than two-thirds of companies could be forced to change their insurance coverage to meet new government standards.[3] Rates for these companies will undoubtedly increase. But so will rates for firms that currently offer insurance that might be considered both adequate and affordable by Health & Human Services. A recent survey by the National Business Group on Health found that an increasing number of business owners who self insure are planning to raise premium rates on employees beginning in 2011. Out-of-pocket maximums and copays are also slated to go up. Large insurers like Anthem and Blue Shield have likewise announced premium increases ranging between 39 percent and 59 percent in some markets. According to the *Wall Street Journal*, "Some consumers could face total premium increases of more than 20 percent." Moreover, many policyholders with plans on the individual market have already seen significant premium increases owing to new regulations that went into effect as of October 1, 2010.

4. Fewer Choices. Health savings accounts (HSAs), used in conjunction with high-deductible health plans (HDHPs), are another tool many small businesses use to provide affordable health care options for their employees. As indicated, PPACA increases the penalty on taxpayers who make nonmedical withdrawals from their HSA. Additionally, over-the-counter medications no longer qualify for HSA spending. Finally, the legality of HSAs will rest on the shoulders of the secretary of the Department of Health and Human Services. A regulatory ruling will be needed to determine if HSA contributions may count toward the actuarial value of high-deductible plans – if not, HSAs will likely disappear.[4]

5. Higher Compliance Costs. The Patient Protection and Affordable Care Act has high compliance costs, including requiring the food service industry to label products with calorie counts (at an estimated cost of 14 million man-hours per year) and requiring doctors to adhere to 153 pages of new federal rules regarding electronic medical records. PPACA has already created 1,000 pages per month of new regulations as published in the Federal Register. One of the most onerous aspects of the law is a provision requiring all businesses, as well as federal, state and local government entities, to file a 1099-MISC tax form on business-to-business transactions exceeding $600. The new 1099 reporting requirement will affect nearly 40 million businesses,

[3] Tanner, 4.
[4] Ibid, 14.

charities and governmental entities, including 26 million sole proprietorships, estimates the IRS. Owing to subsequent legislation passed by Congress, landlords will also be required to file 1099 forms.

5 Ways State Lawmakers Can Cut Taxes and Lower Health Care Costs

Even as businesses face higher insurance and compliance costs because of PPACA, state taxpayers will be responsible for millions in new health care obligations. State Medicaid spending alone is expected to increase by an estimated $1 billion over 10 years. The Legislature could respond by attempting to pass these increased costs on to South Carolina businesses and residents by raising taxes and fees. But if lawmakers are serious about their opposition to PPACA, they should do the opposite. For every new tax, fee and regulation that comes out of D.C., the state should cut taxes and fees and ease regulatory burdens.

1. Lower Personal Income Taxes

PPACA imposes billions in new income taxes on businesses and consumers. These are some basic reforms that would help ease the pain.

- *Create a 100 percent deduction for insurance premiums*. Under current law, insurance premium payments for employer-sponsored plans are excluded from income and payroll taxes. Yet plans purchased on the individual market must be paid for using after-tax income. State lawmakers can help address this inequity by allowing a 100 percent state income tax deduction on out-of-pocket insurance premiums. In 2010, a limited version (S 998) of this idea was introduced in the Senate, but the bill died in committee. (Also see S 180, new for 2011.) Neighboring Georgia, along with several other states, already allows taxpayers to deduct 100 percent of insurance premiums for HDHP/HSA plans.

- *Increase the deduction for medical expenses*. Given that PPACA raises the threshold for medical deductions (from 7.5 percent to 10 percent of adjusted gross income), lawmakers should increase state tax deductions for medical expenses. To begin with, we recommend creating a $1,000 “medical income tax deduction” for all taxpayers to help ease the burden of rising health care costs. In addition, lawmakers should look at providing an additional tax *credit* for all taxpayers whose itemized medical deductions exceed 7.5 percent of federal adjusted gross income (AGI).

1099 Law Will Drown Small Business in Paperwork

According to the National Federation of Independent Business, paperwork created by the 1099 provision alone will increase costs for the average small business by at least $1,776 a year. The new requirement is expected to raise an additional $17.1 billion in taxes. Except even the IRS has expressed “concern that the burdens ‘may turn out to be disproportionate as compared with any resulting improvement in tax compliance.’” While new regulations requiring 1099-MISC filings do not formally go into effect until 2012, some small business owners will be obliged to begin filing in 2011. The Small Business Jobs Act of 2010, for instance, requires landlords to file a 1099-MISC to service providers to whom they paid $600 or more in 2011. The new regulation will cost the average property owner between $400 and $1,600 per year. Repeated attempts to repeal the 1099 provision have failed.

- *Enact a moratorium on capital gains taxes*. South Carolina assesses a 3.92 percent long-term capital gains tax on individuals (7 percent on short-term gains). To help offset increasing federal taxes, the state should place a moratorium on all capital gains taxes until PPACA is repealed. Doing so would also help jumpstart South Carolina's ailing housing market.

- *Provide for a Medicare payroll tax deduction*. South Carolina's share of the payroll tax (3.4 percent on income up to $7,000) is used to fund the state's Unemployment Insurance Trust Fund, which is hundreds of millions of dollars in debt. If cutting the state share of this tax is impractical right now (owing to requirements to pay back federal loans), lawmakers could look at offering an income tax deduction for those small businesses currently not eligible to deduct Medicare payroll taxes.

2. Cut Insurance Premium Taxes in Half

Insurance premium taxes are a kind of income tax imposed on insurers. South Carolina's tax on health insurance premiums is 1.25 percent. The state also imposes an $800 biennial license fee and a $400 biennial fixed license fee that applies to each kind of insurance sold by an individual company (cf. § 38-7-10). Although the state offers several tax credits for insurers (for instance, a health insurance pool tax credit), lawmakers could slash the insurance premium tax in half to help remedy the negative impact of billions of dollars in new taxes on the insurance industry. In addition, the governor should direct the Department of Insurance to conduct a review of premium taxes imposed by South Carolina municipalities, with an eye toward lowering such taxes and also reducing compliance costs.

3. Exempt Health Care Goods and Services from Sales Tax

Prescription drugs, along with other necessities, such as groceries and utilities, are currently exempt from the 5 percent state sales tax. The Tax Realignment Commission (TRAC), however, has recommended imposing a new 2.5 percent sales tax on such items. Instead of passing this new tax, legislators should temporarily suspend the sales tax on all health care goods and services (e.g., over-the-counter drugs) currently subject to the state sales tax. This temporary exemption would help offset new federal taxes on (HSA) over-the-counter drug sales, as well as the new 2.9 percent federal sales tax on medical devices. Once PPACA is repealed, the temporary exemption could sunset.

4. Require Executive Review of All Federal Health Care Funding

Once federal health care funding for specific initiatives (such as state exchanges) begins to roll in, it will be all the more difficult to reduce the state's dependence on this money. One remedy would be for the governor to issue an executive order requiring gubernatorial review and approval of all discretionary federal grant dollars stemming from the Patient Protection and Affordable Care Act. Absent specific authorization, all executive branch agencies would be prohibited from applying for such grants. While the tax implications of this reform are indirect, it would bring an additional level of oversight over state funding requirements that come from the acceptance of federal dollars. Reduced dependency on federal dollars would also help cap total state spending.

In addition, the governor could issue an executive order requiring a moratorium on the PPACA rule-making process. Governors in North Carolina, Arizona and Washington have already issued such orders.

5. Encourage Competition and Opt-Out

Even as PPACA is making health care more expensive for many consumers, the state of South Carolina can enact several reforms aimed at lowering health care costs. These include:

Allowing the sale of out-of-state insurance plans. State law does not require that insurers be domiciled in South Carolina. Rather, all insurers must be licensed by and subject to the supervision of the S.C. Department of Insurance (§ 38-5-10). Likewise, all health maintenance organizations (HMOs) must be granted a certificate of authority from the Department of Insurance (§ 38-33-30). But this licensing process is not so much the problem as is South Carolina's mandated benefits laws, as well as a marketplace dominated by one carrier. According to the S.C. Department of Insurance, Blue Cross Blue Shield holds a 94.7 percent share of the individual market and an 81.4 percent share of the group insurance market.

A reform measure (S 185) pre-filed for the 2011 session would increase competition in the S.C. marketplace by allowing the sale of insurance policies not subject to South Carolina coverage mandates. (Similar legislation was introduced in South Carolina in 2009 and has already passed in Wyoming.)

As we have indicated, such mandates raise the price of insurance by as much as 30 percent in South Carolina. Instead, these policies would be regulated by coverage mandates in their home state, providing an incentive for states to approve mandate-free and mandate-lite policies. Consumers would benefit from lower prices created by a nationwide market for health insurance. State health insurance costs could also decline as increased competition pushes down rates for the state health plan.

Wyoming Opens Insurance Market to Out-of-State Competition

Wyoming is the only state that currently allows the sale of health insurance by out-of-state providers. According to the National Conference of State Legislatures, 16 other states (including South Carolina) have also considered this reform. One state – Rhode Island – has legislation authorizing the creation of a regional health insurance compact. Under PPACA, states may also enter into "health care choice compacts" that permit the sale of health insurance across state lines. The compacts would not go into effect until 2016 and would be regulated by the Secretary of Health & Human Services. In the meantime, federal requirements for minimum benefits will preempt state law (although individual states may impose more stringent requirements). Such requirements will apply to any health care choice compacts, as well as each state exchange. The exchanges are highly regulated state-facilitated markets that will theoretically allow for the purchase of discounted individual and small-group insurance products.

Eliminating Certificates of Need (CONs). A Certificate of Need (CON) is essentially designed to prevent the needless duplication of health care services by requiring government approval for the creation and expansion of health care facilities. As might be expected, CONs don't work, leading to higher costs and less choice. That's one reason the federal government repealed CON requirements in 1987; since then, 14 other states have followed suit. In 2010, the General Assembly (S 337) streamlined the CON process, but also created an additional application fee of $100. Yet the costs of obtaining a CON are already very high and include: a filing fee of $500; an application fee of 0.50 percent of the total project cost (not to exceed $7,000); and an issuance fee of $7,500 for projects greater than $1.4 million. The end result is higher costs for hospitals and other medical facilities.

Opting-out. The Patient Protection and Affordable Care Act allows states to apply for a "waiver for state innovation" that would provide for more flexibility in meeting federally mandated health insurance coverage goals. The waivers are not available until 2017, but a proposal before Congress would move their availability up to 2014.

A more feasible short-term solution is to require the South Carolina Department of Insurance and the Department of Health & Environmental Control to conduct a joint review aimed at determining how many waivers are currently available that allow the state as a whole to opt-out of various provisions of the Patient Protection and Affordable Care Act.

Toward this end, the S.C. Department of Insurance has already made a preliminary request for a waiver from PPACA's Medical Loss Ratio (MLR) rules. The new MLR rules require 80 percent of insurer expenditures (85 percent for larger insurers) to be used to pay actual claims. The rules assume a one-size-fits-all business model that will drive some insurers out of business. More than 30 states have applied/are in the process of applying for a waiver, and South Carolina is expected to obtain one.

Small Business Tax Exemption …
Not Much Help After All

It's no secret many small businesses struggle to provide affordable health care plans for their employees. Targeted tax credits are thought to be a viable means of helping small businesses do so. (Legislation that would have provided for such credits was introduced in 2009; also see S 180). The problem is that targeted credits rarely work. PPACA, for instance, is offering a health care tax credit to small business owners. But according to the National Federation of Independent Business (NFIB), "Very few small businesses will actually qualify for the tax credit," with just "12 percent of the small business population benefitting in any way." For example, only firms with 10 employees or less are eligible for the full credit (and those firms must have an average salary of $25,000/year or less). In addition, the credit will only last six years. Meanwhile, health care spending will continue to skyrocket for years beyond that. The better, long-term solution is to deregulate the insurance market and also provide an income tax deduction that encourages individuals to purchase their own health care coverage.

In addition, the governor could instruct the Department of Commerce to assist South Carolina businesses in obtaining temporary waivers from PPACA coverage requirements. As of mid-December 2010, the White House had already issued 733 waivers affecting millions of individuals. While such waivers are clearly a stopgap remedy, they would help businesses adjust to the new health care climate and, perhaps, hasten repeal of what is clearly an unworkable law.

What's Ahead?

Federal health care legislation is the law of the land. But for how long? In 2010, S.C. legislators considered a measure (S 987) that would have safeguarded the right to pay out-of-pocket for health care. Thirty-eight other states introduced similar legislation, and eight states enacted it. A similar bill (H 3269) has also been pre-filed for the 2011 session. A constitutional challenge to PPACA, however, is fraught with difficulties and should not be the state's default response. In addition, legislators should pass concrete reforms that counteract the detrimental impact PPACA is having on South Carolina's economy and taxpayers right now. Lawmakers should also launch a dialogue on free market health care reform by holding hearings that explore creative ways to reduce health care costs, reduce health care taxes, and improve health insurance coverage. Likewise, the governor should ask the Department of Insurance and the Department of Health & Human Services to work together to formulate a strategy for addressing the health care challenges – how to best help the uninsured, how to reform Medicaid and reduce costs, and how to lower costs for small businesses – unique to South Carolina.

For more information on health care reform, contact Dr. Jameson Taylor at the Policy Council.

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