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The Costs of Claytons Health Insurance Products
The Costs of Clayton’s Health Insurance Products

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and

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Abstract

This paper presents evidence on the extent to which individuals buy private health insurance with the sole purpose of reducing the amount of tax payable under the Medicare Levy Surcharge. Policies that are purchased for this reason are defined as Clayton’s health insurance policies.

Using unpublished ABS data we estimate that more than 200,000 households purchase private health insurance for the sole purpose of tax minimization. In addition to the loss of around $100 million in Commonwealth Government revenue, it is shown that taxpayers who purchase such policies are unlikely to reduce the demand for public hospital services.

It concludes that the current arrangements encourage double dipping into public health funding. Having received financial benefits for purchasing private health insurance, some individuals continue to rely solely on the public health system when entering hospital. A system of ‘mutual obligation’ which would require individuals who receive taxpayer funded subsidies for purchasing private health insurance to use it before relying on the public system is proposed.

Health Funding in Australia

Since the introduction of Medicare in 1975, funding of the health system in Australia has been in a state of flux. While the public health system has remained at the centre of the system since that time, a wide range of policies designed to promote increased reliance on private health funding, particularly
through the encouragement of private health insurance, have been introduced in the interceding years.

A number of authors have raised questions about the efficiency and equity of the current subsidies and incentives introduced by the Coalition government to encourage the uptake of private health insurance (Duckett & Jackson 2000; Smith 2000; Smith 2001a; Smith 2001b; Butler 2001). These papers have all questioned the effectiveness of the 30 percent private health insurance rebate.

This paper considers a more specific issue. Data is presented which supports the claim that a large number of people are purchasing private health insurance with the sole purpose of reducing their tax liability. Insurance policies purchased for their direct tax benefits rather than for their possible health benefits are referred to as 'Claytons' health insurance products.

**The Medicare Levy and Medicare Levy Surcharge**

The Medicare Levy was introduced in 1984 in order to increase the funds available for the provision of public health services in Australia. The levy was originally set at 1 percent of taxable income. It increased to 1.25 percent in 1986, then to 1.4 percent in 1993 and was finally raised to its current level of 1.5 percent in 1995. In 1996, the levy was temporarily increased to 1.7 percent, for the 1996-97 financial year, to fund the gun buy-back scheme.

Apart from exemptions for low-income earners and 'prescribed persons', all Australian taxpayers must pay the Medicare Levy of 1.5 percent of their taxable income. In addition, since 1997 high-income earners have been required to pay the Medicare Levy Surcharge of 1 percent of their taxable income. However, these high-income earners are exempted from the surcharge if they have eligible private health insurance with a registered health fund.

For the purpose of determining liability for the Medicare Levy Surcharge, high-income earners are defined as single taxpayers with taxable incomes in excess of $50,000 and couples or families with taxable incomes in excess of $100,000. The family surcharge threshold increases by $1500 for each child after the first. The surcharge thus adds $500 to the tax bill of singles with taxable incomes of $50,000 and $1,000 to the tax bill of couples and families with taxable incomes of $100,000.
The Medicare Levy is an important source of revenue, raising $4.2 billion in 1999-2000. The Medicare Levy Surcharge, on the other hand, raised only $141 million in the same year. (Australian Taxation Office 2002)

The Government has stated that the aim of the Medicare Levy Surcharge is to 'encourage high-income earners to take out private hospital cover and, where possible, to use the private system to reduce the demand on the public system' (Department of Health and Aged Care 2002).

This paper demonstrates that while the Government may have succeeded in achieving the first objective, in the case of those with Claytons health insurance, they have failed in achieving the second. The validity of achieving the first objective without the second is not made clear by the Government.

Nature of the Problem

An individual who does not want private health insurance but has a taxable income of $50,000 or more will be better off if they can purchase an eligible private health insurance product for less than $500 per annum as their tax savings will be at least $500. A similar situation applies to couples and families. Anecdotal evidence exists that tax accountants are urging their high-income clients to buy low-priced health insurance even if they have no desire to be insured. This assertion is backed up by the evidence presented below that was collected from private health insurers.

After the Medicare Levy Surcharge system was introduced, widespread abuse became apparent. This abuse took the form of customers taking out insurance products with very high excesses. The existence of large excesses not only reduces the direct cost of a claim to the insurer, but it signals that the customer is unlikely to make a claim. In May 2000, the Government stipulated that to qualify for exemption from the Medicare Levy Surcharge the health insurance purchased must have an excess (known in the industry as a 'front-end deductible') of no more than $500 for singles or $1,000 for couples and families. However, the problem remains. The $500 excess continues to operate as a substantial disincentive for those choosing between relying on the health system and reliance on their private health insurance.

In line with the Government's stated objective of reducing pressure on the public hospital system, losses in tax revenue associated with exemptions from the Medicare Levy Surcharge should be offset by reduced expenditure on
public hospitals associated with the shift towards reliance on private health insurance. However, analyses have found that large numbers of people with private health insurance are not declaring themselves as privately insured when they enter public hospitals. For example, the Senate Community Affairs References Committee (2001, p. 72) stated that: 'Of the 403,707 matched separations which took place in (NSW) public hospitals 39 percent used their private health insurance status. The remaining 61 percent did not declare their private health insurance status and were admitted as public patients'.

More recently, Sullivan et al. (2002, p. 12) concluded that: 'This study has shed some light on another unintended result of the PHI (Private Health Insurance) reforms: the apparently increasing trend for some insured patients to behave, at least in their admissions to public hospitals, as if they are uninsured, thus further reducing one important source of income for public hospitals.'

**Extent of the Problem**

Our research shows that some health funds are fully aware of the fact that there is a demand for health insurance products aimed solely at tax avoidance, and market their products accordingly. Most health funds have basic products priced at less than $500 to cater particularly for those who do not want health insurance but do want to avoid paying the Medicare Levy Surcharge. Insurance products that only cover public hospital admissions would have little other purpose.

In the course of gathering information for this paper, call centre operators at various health insurance funds were asked the following question:

Hi, I was speaking to my accountant and he said I could save a lot of tax if I got myself a cheap health insurance policy. I don't really need health insurance, I just want the cheapest policy that will allow me to avoid the Medicare Levy Surcharge. Have you got something that would suit me?

The following comments were recorded.

- We have a policy just for that.
- We have had a lot of inquiries for tax purposes.
- We do indeed; it's going to suit you down to the ground.
It's mostly young people taking this product. They aren't interested in insurance now, but they want to get in now so they don't have to pay a higher price later on.

You'd be surprised just how many people take this out. You can change your policy as your life changes.

Do you need it just for tax purposes?

I think we have something that will do you fine.

You don't need to hear the exclusions do you? Because you're only interested for tax purposes.

Unpublished data from the ABS allows the accurate estimation of the number of high income earners with Clayton's health insurance policies. ABS (2002) questioned a sample representing the 7,660,000 people with private health insurance as to why they had bought health insurance. Of the respondents, 9.6 percent answered: 'To gain government benefits/Avoid extra Medicare levy'.

Some respondents gave more than one answer, but 4.7 percent gave this answer only. The numbers of high-income earners who gave this response only are shown in Table 1.

Table 1: Number of Persons who have Private Health Insurance to Avoid the Medicare Levy Surcharge

<table>
<thead>
<tr>
<th>Gross weekly income of Households</th>
<th>Gave reducing tax as one reason for taking out health insurance</th>
<th>Gave reducing tax as the ONLY reason for taking out health insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000-1,199</td>
<td>94,998</td>
<td>39,291</td>
</tr>
<tr>
<td>$1,200-1,499</td>
<td>113,888</td>
<td>60,608</td>
</tr>
<tr>
<td>$1,500-1,999</td>
<td>114,857</td>
<td>55,719</td>
</tr>
<tr>
<td>$2,000-2,499</td>
<td>67,103</td>
<td>31,127</td>
</tr>
<tr>
<td>$2,500-2,999</td>
<td>37,145</td>
<td>17,512</td>
</tr>
<tr>
<td>$3,000-3,499</td>
<td>21,717</td>
<td>5,821</td>
</tr>
<tr>
<td>$3,500 or more</td>
<td>27,962</td>
<td>5,779</td>
</tr>
<tr>
<td>Total</td>
<td>477,670</td>
<td>215,855</td>
</tr>
</tbody>
</table>

Source: Unpublished ABS data

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1 ABS, National Health Survey, ABS Cat. 4364.0, October 25, 2002. Table 25, p. 62
This unpublished ABS data accords with a reference to the number of Claytons health insurance policies in a recent analysis of the private health insurance industry funded by the Australian Private Hospitals Association (Access Economics 2002) which states that:

Exclusionary policies were developed in an attempt to appeal to the youth market. They made some small inroads after the introduction of the Medicare levy surcharge when they had some appeal to the 'Claytons members' (those who purchased private health insurance primarily because that cost less than the surcharge). However, they did not ever achieve much popularity (peaking at 6.5 percent of the members in June 1999) (Access Economics 2002, p. 17).

According to the Private Health Insurance Administration Council (PHIAC 2002) there were more than 5.7 million persons covered by hospital cover in June 1999. If the Access Economics estimate is correct, this would suggest that more than 370,000 people had Claytons health insurance products.

**Revenue Losses**

In order to determine the loss in revenue associated with the purchase of Claytons health insurance policies it is necessary to determine the following:

- The number of high-income earners who have bought health insurance solely for the purpose of avoiding the Medicare Levy Surcharge;

- The average amount of tax avoided by these individuals.

Unpublished ABS data was used to determine both the number of people who had purchased private health insurance for the sole purpose of avoiding the Medicare Levy Surcharge. The same data was used to determine the distribution of income of those individuals in order to determine the amount of tax being avoided.

Due to the fact that the Medicare Levy Surcharge is only paid by single person households earning between $50,000 and $100,000 it is necessary to estimate the proportion of single earner households in this income range. Table 2 provides data on the proportion of households in the $50,000 to $100,000 income range. All households earning over $100,000 per year are liable for the surcharge.
The lost revenue for each income group is calculated by multiplying the number of people with Claytons cover by the proportion of those liable for the Medicare Levy Surcharge and by the mid-point of the gross weekly income bands. For the highest income group, $4,250 was used as the average income. These results are presented in Table 2.

Table 2: Persons who have Private Health Insurance Solely to Avoid the Medicare Levy Surcharge, Proportion Liable for MLS, and Estimated Tax Avoided

<table>
<thead>
<tr>
<th>Gross weekly income of households</th>
<th>Proportion liable in group</th>
<th>Persons with health insurance ONLY for tax avoidance</th>
<th>Estimated tax avoided ($m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000-1,199</td>
<td>0.18</td>
<td>39,291</td>
<td>$4.14</td>
</tr>
<tr>
<td>$1,200-1,499</td>
<td>0.12</td>
<td>60,608</td>
<td>$5.06</td>
</tr>
<tr>
<td>$1,500-1,999</td>
<td>0.11</td>
<td>55,719</td>
<td>$5.58</td>
</tr>
<tr>
<td>$2,000-2,499</td>
<td>1</td>
<td>31,127</td>
<td>$36.42</td>
</tr>
<tr>
<td>$2,500-2,999</td>
<td>1</td>
<td>17,512</td>
<td>$25.04</td>
</tr>
<tr>
<td>$3,000-3,499</td>
<td>1</td>
<td>5,821</td>
<td>$9.85</td>
</tr>
<tr>
<td>$3,500 or more</td>
<td>1</td>
<td>5,779</td>
<td>$12.77</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>215,855</td>
<td>$98.84</td>
</tr>
</tbody>
</table>

Source: Unpublished ABS data

By combining the number of people estimated by the ABS to have purchased private health insurance with the sole purpose of avoiding the Medicare Levy Surcharge with their average incomes it is conservatively estimated that the amount of tax avoided through the use of Claytons health insurance policies is $99 million per annum.

In arriving at this figure, those who gave more than one reason for taking out private health insurance but whose principal motivation was to avoid tax were excluded. While 215,855 high-income earners mentioned only tax avoidance as their reason in the ABS survey, 477,670 high-income earners gave at least one additional reason. The inclusion of even a small portion of these respondents into the estimate would increase the estimated revenue lost substantially.
It is important to note that Table 2 uses gross income while the thresholds for payment of the Medicare Levy Surcharge apply to taxable income, that is, gross income less allowable deductions. As an approximation, we have allowed for this by converting weekly income to annual income by multiplying by 50 instead of 52, thereby allowing a difference of $2,000 for gross incomes of $50,000 and $4,000 for gross incomes of $100,000. The ATO reports that the average deduction for taxpayers with incomes over $50,000 is $2,405 (ATO 2002, Table 3.3).

Figure 1 shows the distribution by income of those who gave reducing tax as one of their reasons for taking out private health insurance. For those earning between $3,000 and $3,499 the proportion motivated, at least in part, by tax reduction is over 23 percent.

It is interesting to note that there is a increase of more than 5 percent in the proportion motivated to reduce their tax in the $2,000 - $2,499 income group. This is the threshold income group for couples or families.

While the loss of $100 million per year may be only a small percentage of the total health budget, it is, nonetheless, significant. According to figures released by the NSW Health Minister, $100 million per year could, for example, pay for 7,500 hip replacements or 49,000 cataract procedures (Knowles 2002).

Figure 1: Percentage of Respondents who gave Reducing Tax as a Reason for having Private Health Insurance

Source: Unpublished ABS data
Policy Responses

This paper has estimated the revenue costs of a specific element of the current health funding arrangements, the existence of Claytons health insurance policies. The main problem with these products is that they are designed to encourage double dipping into the health funding system. Current arrangements allow people to avoid paying the Medicare Levy Surcharge by taking out private health insurance but do not require them to use their insurance to take pressure off the public hospital system. If substantial subsidies to individuals for the purchase of private health insurance are to remain then, in the language of the Government, a system of 'mutual obligation' should be implemented. Under such a system, individuals who accept government subsidies for private health insurance, either in the form of the 30 percent rebate or the Medicare Levy Surcharge exemption, should be 'obliged' to use that insurance wherever possible. That is, people with private health insurance should be required to use it when they enter public hospitals. The Government should provide public hospitals access to a database of membership details and type of cover for all Medicare patients admitted to a public hospital. All patients with private health insurance for which they have received a taxpayer-funded subsidy would then be required to pay for their stay in hospital, the costs of which they have insured themselves against.

Such an approach would create a causal link between the Government's two stated policy objectives, namely the desire to increase the number of people with private health cover and the expectation that such an outcome will reduce pressure on the public hospital system.

The implementation of a policy of 'mutual obligation' would either induce people to purchase more expensive, but more useable, health insurance or discourage them from claiming the existing health insurance subsidies. Both of these actions would deliver benefits to the health system overall.

Bibliography

Australian Bureau of Statistics (ABS) 2002, 'National Health Survey - Summary of Results', cat. no. 4364.0, ABS, Canberra.


