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## Investment Implications of Health Care Reform

After almost a year of heated debate, the President has achieved his goal of a major reform to the health care system. Over the weekend, the House voted to approve the 2,409 page Senate Bill passed in December, along with 153 pages worth of amendments, based on the understanding that the Democratic majority in the Senate would accept these amendments without alteration. Presuming that Senate Democrats do not renege on their pledge, the combined bills will shortly become law.

So, what does all of this mean for investors?

First, we need to recognize that in discussing this issue, like any other issue in investing, it is critical to leave politics and emotion to one side. People have very strong opinions on all sides of the health care debate - they are entitled to those opinions. These comments are solely focused on the investment implications of the combined bills.

Passing over the generally recognized positive of expanding coverage to roughly 30 million of the 50 million U.S. residents who don't currently have insurance, what does it all mean for the economy and markets?

**Taxes:** The most obvious quantifiable impact of the bill is an increase in taxes for upper income Americans, particularly on investment income. Starting in 2013, the Medicare tax rate on households with income over \$250,000 will be increased from 1.45% to 2.35%. In addition, a new 3.8% Medicare tax will be introduced for the same group on investment income.

Currently, the tax rate on dividends and long-term capital gains is 15%. In 2011, those rates are expected to rise to 20% for households earning over \$250,000, and with the new Medicare tax, these rates will rise to 23.8% for the same group. Under current tax law, investors get to keep 85% of the income stream from taxable stock market investments. Under the new law, this will be cut by 8.8% to

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76.2%, reducing the value of the income stream by 10.4% (that is 8.8% of 85%). This is obviously a significant number. However, it is worth noting three things about this:

- First, roughly half of U.S. stocks are owned by households with income under \$250,000 and roughly half are held in non-taxable accounts. Thus, using a number of broad assumptions, the value of the average stock should be reduced by one-quarter of 10.4%, or 2.6% - not good obviously, but also not an overwhelming reason to avoid stocks after a 12-month period in which they rose by over 70% and still appear undervalued.
- Second, this bill does not put stocks at a further disadvantage relative to fixed income. The maximum federal tax rate on bonds and cash accounts is currently 35% and with tax changes coming in 2011 combined with these changes, that maximum rate will rise to 43.4% for households with income over \$250,000 in 2013.
- And, third, we've been here before. On average, over the past 40 years, the maximum federal tax on capital gains was 24.7% and the maximum tax rate on dividends was 44.6%.

**Medical care industry:** For the medical care industry, this bill will expand demand without much effort to rein in costs. A combination of federal subsidies and mandates will increase the pool of insured individuals, and while there are many constraints preventing insurance companies from limiting coverage, there are few that limit how much they can charge for it.

The pharmaceutical industry will benefit from this, as well as a plan to remove the donut hole from the Medicare prescription drug benefit program by 2020. Early in the debate on health care, the White House negotiated deals with pharmaceutical, insurance and medical device companies to dissuade them from fighting the reform effort. Under these deals, they appear to retain autonomy on price setting. However, they will pay cumulative taxes of \$107 billion between 2011 and 2019. To the extent that they are able to pass these costs on to consumers, they may all do OK in this reform, although they may still be a target for future reform efforts.

The American Medical Association and American Hospital Association have both endorsed the health reform effort with a number of reservations. For the most part, the legislation does not interfere with patient-doctor relationships and, by expanding the pool of the insured, will reduce the number of hours that doctors are forced to devote to charity cases. Most doctors are naturally happy to see patients not lose their coverage due to pre-existing condition clauses, annual caps or non-renewal of existing insurance due to illnesses.

**Federal deficit:** According to the Congressional Budget Office, the passage of this legislation would reduce federal deficits by a cumulative \$143 billion between 2010 and 2019 and by greater amounts in the following decade. However, these estimates should be taken with more than a grain of salt. It is obviously very hard to estimate what total federal health care spending

will be over the next decade. However, whatever else is said about this bill, there is nothing in it to suggest a reduction in either the quantity or prices of health care services consumed.

- There is no meaningful malpractice reform.
- There is no reduction in drug patent lives.
- There is no compulsion to force insurance companies to compete across state lines.
- There is no effort to limit health care procedures in the last year of life.
- There is no movement in the direction of forcing consumers to confront the cost of services at the point of purchase, and,
- There are no meaningful incentives to force the insured to take better care of their own health.

In fact, for the most part, this bill moves away from, rather than toward, the principles of market economics. In 2007, the United States devoted 16% of its GDP to health care spending compared to 11% in the country with the second highest spending, which was France. Despite this, it ranks 38th in the world in life expectancy at birth. Sadly, this bill isn't likely to change either of these numbers for the better.

**The economy:** Despite dire predictions, it's not clear that health care reform will really slow economic growth that much. Most of the tax provisions don't kick in until 2013 and the mandates on businesses and individuals don't kick in in a big way until 2016. Between now and then, the economy is quite capable of staging a full cyclical recovery. It may be that businesses will, in the end, be forced to pay more for the health care of their workers - however, overall, American business is quite capable of limiting wage increases to add to benefit costs. It may be that America as a society ends up spending more on health care. However, if we spend more on health care and less on housing or education or hamburgers, that is our choice. The jobs created in the health care field are, for the most part, American jobs and still some of the highest skilled and best paid jobs out there. It should be noted, however, that to the extent that the government incurs more debt to pay for higher health care costs, it probably does mean higher long-term interest rates.

**Politics:** The passage of health care reform is a huge victory for the President and it may ultimately work out better for him politically than many Republicans had hoped or Democrats had feared. The economy is improving, and if it continues to do so, many may feel that their fears about health care reform were unfounded. The reality is more complicated. Health care reform wasn't about to stop the economy in its tracks anyway and the President will be the beneficiary of a cyclical bounce-back, which, on its face, appears to owe much more to pent-up demand than government stimulus. Either way, the Democrats will lose seats in the mid-term election. However, the end-game for health care reform may well mean less of a swing to the Republicans in November than many had thought.

All in all, a lot to consider but also, more important, a lot to keep in proper perspective.

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