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How Bush's Health Care Tax Plan Will Raise Wages

James Sherk and Nina Owcharenko

President Bush's proposal to replace the current employer-based tax exclusion for employer-provided health coverage with a standard tax deduction of $15,000 a year for family coverage would lead to higher cash income for many Americans. This is because the change would eliminate the incentive for companies to earmark an often excessive proportion of workers' compensation for tax-free health benefits. Instead, they would compensate workers with higher take-home pay.

Companies that today purchase health insurance for their employees often do so because neither employers nor employees have to pay income taxes or payroll taxes on it, unlike for wage and salary income. By limiting the amount of this compensation not subject to taxes, the President's proposal would cause both employers and employees to reconsider how compensation is paid. Rather than devoting a high proportion of their compensation to tax-free health coverage, many workers would decide that a more economical plan made sense and take compensation in other forms. Some might decide to add more compensation to tax-advantaged savings plans, such as 401(k) retirement plans or 529 education savings plans. Other workers would choose to take their income in the form of a pay raise to increase their paychecks.

Wages Versus Benefits. Companies have adjusted to the rapidly rising cost of health insurance in recent years by reducing the amount of compensation they pay as cash wages. For the employer, the most important consideration is the cost of the combined compensation package. So when health care costs rise at slower rates, companies pay their workers more in cash. When health costs rise faster, employers slow the growth of cash earnings.

But a wrinkle in this equation is the tax treatment of benefits—especially health care. Workers do not owe income or payroll taxes on compensation paid in the form of benefits—this is known as the "tax exclusion." The tax break for health benefits is particularly generous because the government also exempts employers from their share of the payroll tax on health benefits. So the government provides a strong tax incentive for employers to give compensation in the form of health benefits. The result is that many workers receive more benefits and lower cash wages than they would prefer in the absence of the tax exclusion.

The effects of the artificial incentive to pay workers in health benefits rather than cash compensation and the impact of rising health costs squeezing cash earnings is evident in recent compensation data. The average employee's total compensation rose 7 percent between 2001 and 2006.[1] Total benefit packages, however, grew much more rapidly than wages and salaries. Almost two-thirds of workers' increased earnings over the past five years have

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Workers' Compensation Gains Since 2001

Total Compensation	7.1%
Wages and Salaries	3.4%
Health Benefits	34.1%
Other Benefits	11.8%

Source: Heritage Foundation calculations based on Bureau of Labor Statistics, Employer Costs for Employee Compensation (ECEC) data for all civilian workers.

come in the form of increased spending on benefits, with only a third going into higher pay.[2]

Of those benefits, the greatest increase has come in what employers spend to provide their workers with health care. While wages have risen 3 percent since 2001, employer spending on health benefits has risen 34 percent.[3] Consequently, the share of compensation taken up by employer-provided health care is rising. These health benefits are now worth 11 percent of the average worker's paycheck, up from 8 percent in 2001.[4] Companies are using money that would have gone towards higher wages to pay for health care.

What the Research Shows. Many economists have examined the data and found that employers' spending on benefits is essentially interchangeable with spending on wages and salaries. In states where rising medical malpractice costs drove up the costs of health insurance, workers paid for the higher premiums almost dollar-for-dollar with lower wages. In states where medical malpractice insurance costs have remained low, and thus health insurance less expensive, workers received the savings in the form of higher wages.[5]

Similarly, many states have passed laws mandating that health insurance plans cover childbirth costs. This makes providing health insurance to women of childbearing age and their husbands more expensive. Research has shown that companies respond to these laws by reducing the wages of their female and married male employees by the same amount that the health insurance premiums for their employees' coverage rose.[6] Workers, not employers, ultimately bear the cost when health care becomes more expensive.

Giving Workers Control. The Bush plan would require companies to disclose the cost of their group coverage and then would limit the value of coverage that could be shielded from taxation. The tax-free maximum would be $7,500 for individuals and $15,000 for families. This limit would encourage workers to review the structure of their taxable and non-taxable compensation. Workers who now have coverage that costs more than this limit would face a strong incentive to consider whether to negotiate for the now-taxable health compensation in some other form, such as cash or tax-free savings for retirement. In many instances, employers and employees would agree to cut back on "gold-plated" health coverage in favor of higher wages that would make up the difference.

An increasing number of firms offer flexible benefit "cafeteria" plans in which employees choose their own wage and benefits packages, spending as much

1. Heritage Foundation calculations based on Bureau of Labor Statistics, Employer Costs for Employee Compensation (ECEC) data for all civilian workers, adjusted for inflation with the CPI-U-RS. The ECEC published data for the first quarter of each year until 2002, so the data for 2006 come from the first quarter of that year in order to maintain comparability with 2001 data.
2. *Ibid*. About 65 percent of the increased compensation was spent on benefits, with the remaining 34.9 percent going to higher wages.
3. *Ibid*. Wages have risen 3.4 percent, after adjusting for inflation using the CPI-U-RS, while spending on health benefits has risen 34.1 percent.
4. *Ibid*. The ratio of employer-provided health insurance to wages and salaries for all civilian workers was 10.9 percent in the first quarter of 2006, versus 8.4 percent in the first quarter of 2001.
5. Katherine Baicker and Amitabh Chandra, "The Labor Market Effects of Rising Health Insurance Premiums," NBER *Working Paper* No. 11160, February 2005, at *papers.nber.org/papers/w11160*.
6. Jonathan Gruber, "The Incidence of Mandated Maternity Benefits," *The American Economic Review*, June 1994, Volume 84, No. 3, pp. 622–641.

of their earnings on health coverage as they see fit.[7] When the cost of health care rises, many workers with cafeteria coverage opt for more economical health coverage and devote compensation to other priorities, such as education or retirement savings.

A detailed National Bureau of Economic Research analysis of workers at one company that offered a cafeteria plan found that for each dollar that the cost of health care rose, workers chose to increase the amount of compensation they devoted to health care by only 52 cents. They paid for that by reducing their wages 37 cents and reducing spending on their other benefits by 15 cents.[8] These workers made a conscious decision about how they wanted to spend their money and were able to do it in the way that they, not their employer, saw fit.

Conclusion. By limiting the tax relief for company-sponsored health coverage, the President's health plan would encourage workers and their employers to review the structure of compensation. Today that structure is effectively hidden from most employees, and the tax system encourages companies to pay compensation as tax-free health benefits rather than cash. The President's plan would encourage workers to tailor compensation to meet their unique needs, and many would choose to receive more compensation as cash wages.

—James Sherk is Bradley Fellow in Labor Policy in the Center for Data Analysis, and Nina Owcharenko is Senior Policy Analyst for Health Care in the Center for Health Policy Studies, at The Heritage Foundation.

7. About 17 percent of all employees work in jobs that offer flexible benefit plans. Bureau of Labor Statistics, U.S. Department of Labor, "National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2006," August 2006, Table 24, at *www.bls.gov/ncs/ebs/sp/ebsm0004.pdf*. In 1997, only 13 percent of workers in medium and large companies had access to flexible benefit plans. Bureau of Labor Statistics, "Employee Benefits in Medium and Large Private Establishments," News Release, January 7, 1999, Table 2, at *www.bls.gov/news.release/ebs3.toc.htm*.
8. Dana Goldman, Neeraj Sood, and Arleen Leibowitz, "Wage and Benefit Changes in Response to Rising Health Insurance Costs," NBER Working Paper No. 11063, January 2005, at *papers.nber.org/papers/w11063*.