

# WORKING PAPER

## *Executive Summary*

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## EFFECTS OF EMPLOYER HEALTH COSTS ON THE TREND AND DISTRIBUTION OF SOCIAL SECURITY-TAXABLE WAGES

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Over the past six decades, U.S. health care costs have increased much faster than employee compensation and consumer prices. Over that same time span, American employers assumed a growing role in insuring their workers' health care expenses. The great majority of wage and salary workers and their dependents now receives health insurance through employer-based plans. Employer contributions for employee health plans increased from 0.5 percent of compensation in 1950 to 7 percent in 2010. Since 1980, all of the decline in the ratio of money wages to total employee compensation has been due to the rising share of employee health.

These trends have important implications for the Social Security tax base. Money wages, but not employer contributions for health benefits, are included in taxable earnings. Under the assumption that workers ultimately bear the cost of employer-provided health benefits through lower wages, the rapid growth in health costs reduces the share of employee compensation included in the tax base. In recent decades, the outsize growth in health costs has also been accompanied by a rise in wage and compensation inequality.

This paper examines the relationship between rising employer health costs and growing wage inequality using wage and insurance premium data in the Medical Expenditure Panel Survey (MEPS) household and employer survey files. Although health insurance coverage is more frequently offered to employees earning high wages, it represents a larger percentage of wages for low- and moderate-pay employees. In 2007 and 2008, employer health contributions represented 10 percent or more of the average pay of workers in the 2nd through the 7th wage deciles but less than 5 percent of the wages of earners in the top one-tenth of the wage distribution.

During the years we analyze, 1996-2008, we find only modest changes in the insurance coverage of wage and salary workers and somewhat larger changes in the percentage of workers who opt for more costly family plans. The proportion of workers who enrolled in more costly plans fell in every wage decile. Nonetheless, employer outlays on employee health plans rose considerably faster than wages in every part of the wage distribution except among the bottom one-tenth of wage earners. In the top 80 percent of the wage distribution, employer contributions for employee health plans increased at approximately the same rate, about 6.9 percent per year. However, employer health premiums represent a larger percentage of total compensation in the middle and near the bottom of the distribution than they do at the

top. Consequently, the growth in employer health costs absorbed a larger percentage of compensation gains in the middle and at the bottom of the wage distribution – except at the very bottom – compared with the top of the distribution.

Differences in the rate of growth of wages reinforced this differential effect of rising health costs. Wages grew faster at the top of the distribution, especially above the Social Security taxable wage ceiling, compared with the middle and bottom of the distribution. Over the historical period we analyzed, national health spending and wage statistics show that employer health insurance premiums per worker increased 5.77 percent a year, while annual money wages increased 3.93 percent a year among earners with wages below that taxable maximum and 4.50 percent a year among earners with wages above the maximum. In simulations, we find that the combined effect of rising health costs and increased wage inequality was to reduce significantly the share of Social-Security-taxable wages in employee compensation. Among earners with wages below the taxable wage ceiling, we estimate that increased employer health costs reduced the fraction of compensation consisting of taxable wages by 1.43 percentage points between 1996 and 2008. For earners above the taxable wage ceiling, the combined effect of rising health costs and growing inequality reduced the share compensation that was taxable by Social Security from an estimated 44.9 percent to 42.2 percent of compensation. If employer health costs had instead increased in proportion to the rate of compensation increase above and below the taxable wage ceiling, the Social Security tax base would have been 1.7 percent larger in 2008. We project that the tax base would be 3.8 percent larger by 2020 if employer health costs grew between 1996 and 2020 at the same rate as employee compensation.

We also estimate the potential effects of the Affordable Care Act on money wages and the Social Security tax base in 2016, when the major provisions are scheduled to be fully implemented. In making our estimates we ignore the possible effects of the law on the trend in overall health costs. The 2010 health reform law is expected to increase the proportion of working-age adults and their children who are insured. Some of the increased coverage will occur because more large employers will be induced to offer health plans to their workers, in part because of financial penalties. Other increases in coverage will occur because Medicaid income eligibility limits are increased, boosting the percentage of workers and dependents receiving government insurance. Finally, other uninsured workers will obtain insurance through state health insurance exchanges, which are expected to make affordable health plans available to a wider cross-section of working-age adults.

Under the maintained assumption that total employee compensation will remain unchanged for each worker, we calculate the effects of changes in the source of health coverage on the division of employee compensation between money wages and employer contributions for health insurance. On balance we find that health reform is likely to increase employee compensation in the Social Security tax base, though only by about 0.3 percent. The main reason is that some employers of low- and middle-wage workers are likely to see some of their employees switch into subsidized insurance plans provided through Medicaid and health insurance exchanges.

The more profound effect of health reform on taxable employee compensation will probably occur through a different channel. If insurance reform leads to slower long-term growth in health care spending, a larger fraction of future compensation will take the form of money wages.

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