Give Up A Benefit, Gain Jobs

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Abstract

Employer-paid health insurance is entirely tax-free — a break that will cost the Treasury about $250 billion this year. Len Burman looks at tax-free health insurance provided by employers.

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By Len Burman

With union membership shrinking and wages strained, it might sound crazy to argue that labor should voluntarily give up a huge fringe benefit: tax-free health insurance provided by employers. But it should. In the long run, capping the amount of health insurance that employers can provide tax-free would raise workers' wages, partially protect them from layoffs and speed rehiring after a downturn.

Right now, employer-paid health insurance is entirely tax-free — a break that will cost the Treasury about $250 billion this year. If an employer pays $12,000 for health insurance, that money is not counted as income, whereas the same $12,000 paid as cash wages is subject to income, Social Security and Medicare taxes. The more generous the insurance policy, the bigger the tax savings.

Health experts criticize this arrangement because it encourages employers to provide health insurance plans that cover everything; this, in turn, contributes to overspending on health care by workers who have no incentive to pay attention to costs.

A cap would limit the tax benefits to a dollar threshold. If the cap on family coverage were, say, $12,000, the policy described above would still be tax-free, but a "gold-plated" $20,000 policy wouldn't be. The $8,000 above the cap would be taxed, just like cash wages.

Unions object to the cap because they have worked hard to negotiate extremely generous health benefits for their members. With a flat cap, many union workers would pay higher taxes. To protect union workers from the tax increase, some proposals would limit the cap to those with very high incomes, but that approach would raise little revenue and wouldn't rein in health spending much.

More important, in the long run, a cap could help union workers. For one thing, it would require employers to reveal what they pay for health insurance. If machinists earning $50,000 a year knew that their employers were paying $20,000 for their health insurance, many would ask them to find a cheaper plan (such as an HMO) and boost wages.

What's more, that $20,000 health insurance plan is what economists call a fixed cost. Every full-time worker comes with that baggage. The problem with fixed costs is that they create an incentive for employers to reduce the number of their full-time workers, particularly in a recession. Consider: An employer facing sharply reduced demand for its product might reduce the number of hours worked by its current workforce in an effort to spread the pain. If workers earn $25 per hour and their workweek is cut by five hours, the firm saves $125 per worker per week. Reduce hours for eight workers, and the firm saves $1,000 per week, the wage bill for one full-time worker.

But if the firm also pays $400 per worker each week for health insurance, it could save more by laying off one worker. The firm would save the weekly salary of $1,000 plus the $400 health insurance bill, for a total savings of $1,400. The fixed cost encourages layoffs.

By similar logic, when the economy starts to recover, employers prefer to expand hours for existing workers (or hire more part-timers who do not receive benefits) than hire back laid-off workers. That is one reason employment rises so slowly when the economy perks up.

Unions understand these incentives and try to negotiate limits on such maneuvers, but encouraging firms to ignore the bottom-line pressure created by excessive fixed costs makes them less able to compete in domestic and global markets. That gives nonunion firms an edge over unionized firms.

If the cap encourages employers to turn excessive health benefits into wages, unionized companies can better adapt to changing market conditions, helping both unions and workers. And if employers replace Cadillac health plans with Chevy plans, their employees might be able to afford other useful stuff, like Chevy automobiles.

An effective cap would bring in enough revenue to make health reform possible, something unions have long sought. A cap that was set at the average premium level in 2009 and that grew with inflation would raise almost $850 billion in income and payroll tax revenue over the next decade -- more than half the cost of the plan for universal coverage that President Obama proposed during the campaign.

Unions should embrace the cap.

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