



Compensating wage differentials and the impact of health insurance in the public sector on wages and hours



Paige Qin^a, Michael Chernew^{b,*}

^a Harvard University, United States

^b Harvard Medical School, 180A Longwood Avenue, Boston, MA 02115, United States

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ABSTRACT

This paper examines the trade-off between wages and employer spending on health insurance for public sector workers, and the relationship between coverage and hours worked. Our primary approach compares trends in wages and hours for public employees with and without state/local government provided health insurance using individual-level micro-data from the 1992–2011 CPS. To adjust for differences between insured and uninsured public sector employees, we create a matched sample based on an employee's propensity to receive health insurance. We assess the relationship between state contribution to the health plan premium, state-level healthcare spending, and the wages and hours of state and local government employees. We find modest reductions in wages are associated with having employer-sponsored health insurance (ESHI), although this effect is not precisely measured. The reduction in wages associated with having ESHI is larger among non-unionized workers. Further, we find little evidence that provision of health insurance increases hours worked.

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In July 2012, the State Budget Crisis Task Force, led by former New York Lieutenant Governor Richard Ravitch and former Federal Reserve Board Chair Paul Volcker, released a report that examined the major threats to states' fiscal sustainability in the aftermath of the 2008 financial collapse. State and local expenditures on Medicaid and health care compensation for current employees and retirees were identified as the leading causes of long-term fiscal imbalances for state and local governments ([State Budget Crisis Task Force, 2012](#)). In an estimate provided by the United States Government Accountability Office (GAO) in April 2012, health-related spending for state and local governments would be around 3.9% of national GDP in 2012 and 7.1% of GDP in 2060. In contrast, the sector's non-health-related spending—such as the wages and salaries of state and local employees—was projected to decline as a percentage of national GDP, from about 10.4% of GDP in 2012, to 7.8% of GDP in 2060 ([GAO, 2012](#)).

This paper explores the relationship between insurance coverage and wages and hours of state and local government workers. Additionally, we explore the variation in state contribution to health insurance premium as well as state personal health care spending and examine their association with the wages and hours of public sector employees.

In total, state and local governments reported an annual spending of \$2.5 trillion in 2009 and employ over 19 million workers, or 15% of the national work force and 6 times as many employees as the federal government ([State Budget Crisis Task Force, 2012](#)). These workers include state and local government administrators, but also teachers, police officers and hospital employees. At the same time, almost all states have balanced operating budget requirements, which restrict borrowing across fiscal years.¹ Furthermore, the structural imbalance in state budgets is exacerbated by the financial collapse of 2008; it took until the third quarter of

* Corresponding author. Tel.: +1 617 432 0174.

E-mail address: Chernew@hcp.med.harvard.edu (M. Chernew).

¹ State and local governments often do not pre-fund liabilities such as pension and health insurance obligations to retirees. As these liabilities increase over time, the full costs of these benefits are not fully funded by state and local governments.

2011 for state and local government total tax receipts to return to pre-recession levels of 2007 (State Budget Crisis Task Force, 2012).

Compared to their counterparts in the private sector, most public sector employees have employer-sponsored health insurance, enjoy lower deductibles and pay a much smaller share of the higher premium as a result of the lower deductibles (Clark et al., 2012).

The theory of compensating wage differentials predicts that holding human capital and other variables influencing wages constant, individuals receiving higher fringe benefits are paid a lower wage than those receiving lower fringe benefits (Rosen, 1986). Therefore, as spending on health insurance rises, employers that provide workers with health insurance will lower wages, in order to keep total compensation the same (Summers, 1989). However, the situation in the public sector is complicated by state and local governments' limited ability to adjust wages, as salaries and employee benefits are often determined by union contracts.

The literature also examined the labor market's response to rising employer spending on health insurance along other margins. Given health insurance's status as a fixed cost per worker and wages as marginal cost per hour worked, an increase in fixed costs relative to marginal costs has led firms to substitute longer work weeks per employee for additional number of workers (Cutler and Madrian, 1998).

The paper proceeds as follows. Section 1 presents previous evidence on labor market responses to increased health insurance spending. Section 2 describes the individual and state-level data we use. Section 3 contains the econometric methodology used to estimate the compensating wage differentials and changes in hours worked. Section 4 presents the results and concludes given the empirical findings.

1. Evidence on labor market responses to increasing spending on health insurance

A standard compensating wage differential framework would involve regressing wages on the availability or cost of employer-sponsored health insurance, with an expected negative coefficient on the health insurance variable. However, as Currie and Madrian (1999) put it, most estimates of the average market value of employer-sponsored health insurance (ESHI) are either positive (wrong-signed), insignificant, or both. The challenge lies in eliminating omitted variable bias where unobserved human capital variables are often correlated with employer-sponsored health insurance status (i.e., more capable workers are more likely to receive employer-sponsored health insurance and higher wages).

Of the recent papers that examine the relationship between wages and having health insurance, there is variation in the estimated value of health insurance as a percentage of wage compensation depending on sample selection and the estimation techniques used. For example, taking advantage of the rotating panel design of the Consumer Expenditure Survey (CEX) to track workers who changed health insurance status between the 2nd and 5th interviews, Miller (2004) used person fixed effects and found that having health insurance led to a 10–11% wage reduction among prime-aged male workers. Using husband's firm size and union membership as instruments for wife's health insurance coverage, Olson (2002) found that health insurance was valued at 20% of overall wages among employed married women.

Studies that estimate the wage offset as a function of employer spending on health insurance report full or nearly full cost shifting to wages (Eberts and Stone, 1985; Gruber and Krueger, 1991; Lubotsky and Olson, 2010). There is also evidence of group-specific cost shifting—i.e., relatively slower wage increases for particularly

expensive groups such as older workers, workers with family insurance coverage and women of child-bearing age (Sheiner, 1995; Gruber, 1994).

The implication that full cost shifting of employer health insurance payment to employee wages should have no effect on the equilibrium level of labor utilization is empirically confirmed by several studies (e.g., Gruber and Krueger, 1991; Gruber, 1994). However, despite the lack of overall change in labor input, the rise in health insurance spending has led to changes in the compositional mix of labor utilization—specifically, employers are responding to the rise in fixed employment costs by increasing hours per insured worker and decreasing employment (Cutler and Madrian, 1998; Gruber, 1994). There is somewhat mixed evidence on whether employers are expanding the share of the workforce that is ineligible for benefits (Montgomery and Cosgrove, 1993; Buchmueller, 1999).

Several important issues remain unaddressed in the current literature. First, most of the findings on compensating wage differentials and hours do not distinguish between public and private sector workers, or are solely based on private sector industries. Cutler and Madrian (1998)'s finding that hours rose the most in industries with the fastest growth rates of health care spending excludes public sector employees. Very few papers to date have examined whether the competitive, private sector model of health benefits-wage trade-offs exists in the public sector, where wages are more rigid. Using data on school district finances in 1998 and 2007, Clemens and Cutler (2013) found that only a small fraction (around 15%) of the growth in benefit costs—including increases in both health care and pension costs—are offset through reduction in the wages of school district employees. In an earlier study of retirement system characteristics and wages of uniformed municipal employees, Ehrenberg (1980) found that increased employee pension contributions led to a compensating increase in their salaries and more generous retirement systems are associated with lower wages. To the extent that health care compensation for its employees is threatening the fiscal sustainability of state governments, it becomes important to gather evidence on the response of public sector wages and hours to rising health care spending.

An important consideration when studying health insurance spending-wage trade-offs in the public sector are the roles played by public sector unions in negotiating employee benefits and wages. As noted by DiSalvo (2010), the dramatic growth of public sector unions during the second half of the 20th century has led unionized public sector employees (7.9 million) to overtake unionized private workers (7.4 million) in numbers for the first time in 2009. The aggressive political actions taken by public sector unions to both increase union members' total compensation and the size of the public sector—using their unique position as the monopoly provider of government services—have occasionally been met with reformist moves, such as when New Jersey Governor Chris Christie issued an executive order banning state workers' unions from making political contributions; however, rarely have these political counter-attacks against union power been successful. A recent paper (Anzia and Moe, 2012) found that unions increase the costs of government in the form of higher wages, better benefits and job protection for their workers, and these effects are substantively significant; specifically, municipal fire departments with collective bargaining during the 1990s spent 9% more per employee on salaries and wages, and 25% more on health and life insurance benefits, without decreasing fire protection employment levels. Another paper, Edwards (2010), quantified the increase in total compensation costs for state and local workforce due to public unionism to be 8.1%. Clemens and Cutler (2013) found that strong teachers unions mediate the relationship between benefit growth and increases in

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