

The Health Wedge and Labor Market Inequality

Based on BFI Working Paper No. 2023-50, "[The Health Wedge and Labor Market Inequality](#)," by Amy Finkelstein, MIT; Casey C. McQuillan, Princeton University; Owen M. Zidar, Princeton University; and Eric Zwick, Chicago Booth

The pervasiveness of employer-provided healthcare in the United States contributes to labor market inequality; under an alternative scenario where healthcare is funded by a payroll tax on firms, the college-wage premium would be 11% lower. If healthcare costs had grown at the rate of other countries, inequality would have grown less as well.

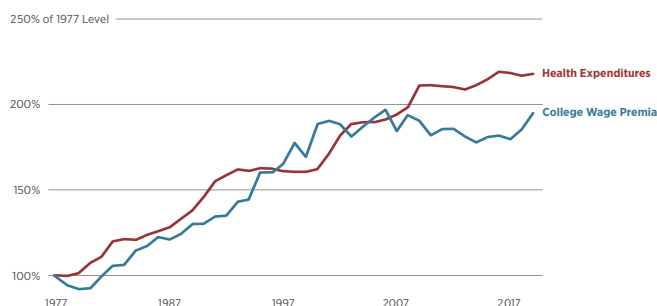
The US health system, in which most people receive insurance through an employer, is often criticized for generating disparate health outcomes. Recently, critics have also pointed to its harmful effects on labor market inequality. Their logic is straightforward: Because firms pay approximately the same amount to insure high- and low-wage employees, the current scheme raises the cost of low-skilled labor more than it does the cost of high-skilled labor. Average insurance premiums for employer-provided health insurance were about \$12,000 in 2019, equal to roughly 25% of annual earnings for

a worker without a college degree (about \$50,000), and about 12% for a worker with a college degree (about \$100,000). As healthcare costs rise, this so-called "health wedge" becomes larger.

This paper aims to quantify the importance of the health wedge, using data on earnings for degree holders and non-degree holders, coupled with information about insurance and employment to construct a model of the labor market and predict the impacts of alternative healthcare policies. The authors find the following:

- Funding health insurance with a national payroll tax proportional to earnings that is levied on firms would reduce labor market inequality considerably. If this approach had been adopted in 2019, there would have been an additional 500,000 full-time jobs available for workers without college degrees. Average annual earnings for non-degree-holding workers would have been about \$1,700 higher, and the earnings gap between workers with and without college degrees would have been 11% smaller.
- Had this policy been in place since 1977, the rise in the college wage premium would have been about 20% smaller and the rise in non-college employment about 4.6% larger.

Figure 1 • College Wage Premia and Health Expenditures in US Over Time

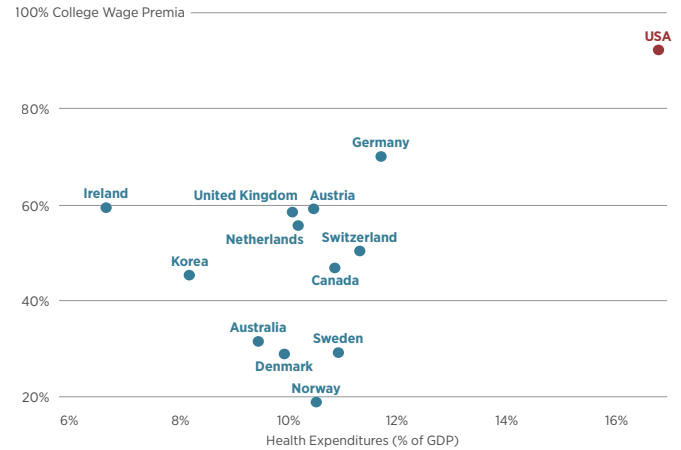


Note: This graph shows health expenditures as a share of GDP in red and the college wage premium in blue over time in the United States. Both are measured as a percentage of their 1977 level. As you can see, healthcare spending as a share of GDP has roughly doubled in the US, as has the college wage premium.

- These effects are comparable to some of the other leading drivers of labor market inequality, including outsourcing, robot adoption, rising trade, declining unionization, and the decline in the real minimum wage. Note that these mechanisms are not necessarily competing, as some (such as the shift to outsourcing and offshoring) may result from rising healthcare costs.
- If health care spending in 2019 (as a share of GDP) had remained at the 1977-level of 7.7% (rather than rising to 16.8%), the college wage premium would be about 11% lower and non-college wages would be about \$6,000 (or 12%) higher.
- If health care spending in 2019 had been the same as in Canada — approximately 10.8% of GDP instead of 16.8% — the college wage premium would have been 5% lower and non-college earnings would have been \$2,800 (or 5%) higher.

The upshot is that our current approach to financing healthcare results in significant labor market inequality between those with and without college degrees. While the authors stop short of recommending a new tax system, they note that employer-provided health insurance is subsidized heavily through the exclusion of employers' contributions to their employees' health insurance premiums from employees' taxable income. This tax exclusion amounts to about \$300 billion a year, making it the single largest federal tax expenditure and an expense that merits reconsideration in light of this research.

Figure 2 • College Wage Premia and Health Expenditures Across Countries in 2019



Note: This graph plots the relationship between college wage premia and health expenditures in 2019 across a set of countries where the GDP exceeds 300 billion USD. As you can see, the US is an outlier both in terms of the size of the healthcare sector and the college wage premium.

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