Journal of Public Economics 84 (2002) 305–339
www.elsevier.com/locate/econbase

The effect of tax subsidies to employer-provided supplementary health insurance: evidence from Canada

Amy Finkelstein*

Department of Economics, MIT, 50 Memorial Drive, Cambridge, MA 02142, USA

Received 21 March 2000; received in revised form 17 September 2000; accepted 25 September 2000

Abstract

This paper presents new evidence of the effect of the tax subsidy to employer-provided health insurance on coverage by such insurance. I study the effects of a 1993 tax change that reduced the tax subsidy to employer-provided supplementary health insurance in Quebec by almost 60%. Using a differences-in-differences methodology in which changes in Quebec are compared to changes in other provinces not affected by the tax change, I find that this tax change was associated with a decrease of about one-fifth in coverage by employer-provided supplementary health insurance in Quebec. This corresponds to an elasticity of employer coverage with respect to the tax price of about −0.5. Non-group supplementary health insurance coverage rose slightly in Quebec relative to other provinces in response to the reduction in the tax subsidy to employer-provided (group) coverage. But the increase in the non-group market offset only 10–15% of the decrease in coverage through an employer. The decrease in coverage through an employer was especially pronounced in small firms, where the tax subsidy appears much more critical to the provision of supplementary health insurance than it does in larger firms.

Keywords: Employer health insurance; Tax subsidies

JEL classification: H24; I18; J32

1. Introduction

In both the United States and Canada, private health insurance is primarily

*Tel.: +1-617-258-0741; fax: +1-617-253-1330.
E-mail address: afink@mit.edu (A. Finkelstein).

0047-2727/02/$ – see front matter
PII: S0047-2727(00)00155-9

obtained as an employee benefit. In the United States, almost 90% of the non-elderly with private health insurance are covered through their employer (Employee Benefits Research Institute, 1995). In Canada, almost all private health insurance – which primarily covers out of hospital prescription drugs since these are not covered by the public health insurance system – is provided through an employer.[1] There may be efficiency reasons for the prevalence of such insurance through the workplace. Economies of scale in the administration and underwriting of policies make it cheaper for firms (particularly large ones) to provide benefits. In addition, pooling workers of different health risks can reduce the scope for adverse selection that is present in the market for non-group health insurance.

The predominance of employer provision may also be a function of the tax system. Both Canada and the United States subsidize employer provision of health benefits by excluding employer contributions to these benefits from the employee's taxable income. These tax subsidies constitute major expenditures for their respective governments. In the United States, the tax exclusion of employer-provided health insurance is the largest single tax expenditure, costing the federal government $US 72.5 billion in foregone federal income tax revenue in fiscal year 1999 (Office of Management and Budget, 1999). In Canada, the exclusion cost the federal government approximately $CA 1.6 billion in lost federal tax revenues in 1998. (Government of Canada, 1998).[2]

There is little empirical evidence with which to estimate of the expected effects of a reduction in this tax subsidy on the extent of coverage through the workplace. Most of the existing literature is based on comparing health insurance coverage across workers with different marginal tax rates and hence different tax subsidy rates. As is discussed in greater detail below, such analyses are unlikely to estimate consistently the effect of the tax subsidy on coverage by employer-provided health insurance. However, a recent major reform to the tax subsidy in Canada provides an opportunity to consistently estimate the effect of the tax subsidy on coverage by employer-provided supplementary health insurance. In May 1993, the Quebec government removed the exclusion of employer contributions to health and dental benefits from an employee's provincial taxable income.

[1] There do not appear to be any comprehensive statistics on the non-group health insurance market in Canada. However, calculations by the author, based on the annual surveys of the Canadian Health and Life Insurance Association, suggest that less than 3% of individuals with private health insurance in Canada are covered by the non-group market. These data (and their limitations) are discussed in more detail in Section 4.4.

[2] Both the US and Canadian figures include lost revenue from the tax subsidy provided to medical expenditures above a certain fraction of income. The total loss in revenue from the tax subsidy to employer-provided health insurance is considerably higher once foregone revenues from state (or provincial) and payroll taxes are considered.