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How elastic is the firm's demand for health insurance?

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Abstract

We investigate the impact of tax subsidies on the firm's decision to offer insurance, and on conditional firm spending on insurance. We do so using the micro-data underlying the Employment Cost Index, which has a major advantage for this exercise: the matching of very high quality compensation data with information on a sample of workers in the firm. We find that, overall, there is a moderately sized elasticity of insurance offering with respect to after-tax prices (-0.25), and a larger elasticity of insurance spending (-0.7). We also find that the elasticities are driven primarily by small firms, for whom the elasticity is larger. And we find that there is significant value added to this employer-based data: replicating methods from standard micro-data sources in our data lead to misleading estimates of these key parameters. Our simulation results suggest that major tax reform could lead to an enormous reduction in employer-provided health insurance spending.

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1. Introduction

The dominant feature of the health insurance market in the U.S. is the provision of private health insurance through the workplace. In 1998, 91% of the privately insured non-elderly population, representing 65% of the total non-elderly population, received their

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insurance through the workplace (EBRI, 2000). There are a number of reasons why health insurance may naturally be provided through the workplace in the U.S. There may be substantial economies of scale in administering insurance which increases the value of pooling mechanisms. Workplaces provide a natural pooling mechanism along dimensions largely exogenous to health status. And, finally, the U.S. tax code subsidizes health insurance purchase through the firm relative to the non-group market by excluding the value of that insurance from an individual's income, a tax exclusion estimated to cost more than \$100 billion in foregone federal, state and local tax revenues in 1999 (Sheils and Hogan, 1999).

This tax subsidization of employer-provided insurance has been criticized along a number of dimensions. First, relative to a flat credit, a deduction for health insurance expenditures is regressive, providing the largest tax break for the most well off employed persons. Second, the tax system subsidizes insurance purchases over purchases of other goods, distorting individuals towards increased insurance purchase; some (e.g. Feldstein, 1973) have claimed that this leads to 'overinsurance' and, perhaps, ultimately to excess cost inflation in the health care sector.

While the first of these criticisms is unassailable, assessing the validity of the second requires understanding the impact of the tax subsidy to employer-provided insurance on the amount and nature of employer-provided insurance. As a result, over the past 25 years a large number of articles have assessed the responsiveness of employer-provided insurance to its after-tax price. Unfortunately, this literature has led to a wide range of estimates, from roughly zero to almost -6 .

This wide range likely reflects two important limitations of the previous literature. One is that many articles in this literature have been unable to control for confounding factors correlated with both the after-tax price of insurance and the demand for insurance; this limitation has been addressed to some extent by more recent work. The second is that all of the work in this literature has either used data at the level of the firm, or at the level of randomly selected workers in firms (through individually based micro-data sets). The disadvantage of the first of these is that we do not observe the characteristics of the workers to whom the firm is responding. The disadvantage of the second is that, with any workforce heterogeneity, the firm may not be responding solely to the demand of the randomly observed worker. While this weakness has been recognized, it has not been effectively addressed, due to the well-known (and well-lamented) absence of data with information on both firm benefits provision and details on a sample of workers in that firm.

In this paper we address these difficulties by drawing on an excellent data source that provides high quality information on insurance offering, insurance spending, and, most importantly, information on the distribution of characteristics of workers in each firm. These are the micro-data of the National Compensation Survey, which underlie the well-known Employment Cost Index (ECI) measure of inflation. We match these data, from the 1983 through 1995 period, to information on the tax subsidy to insurance faced by the workers. This tax subsidy varies across workers of different income levels, over time, and across states, providing substantial exogenous variation in the after-tax price of insurance. And we use this unique information on the workers within a firm to create firm-specific tax subsidy measures that more closely correspond to the appropriate firm subsidy.

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