

Worker sorting, compensating differentials and health insurance: Evidence from displaced workers

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Abstract

This article introduces an empirical strategy to the compensating differentials literature that (i) allows both individual observed and unobserved characteristics to be rewarded differently in firms based on health insurance provision, and (ii) selection to jobs that provide benefits to operate on both sides of the labor market. Estimates of this model are used to directly test empirical assumptions that are made with popular econometric strategies in the health economics literature. Our estimates reject the assumptions underlying numerous cross sectional and longitudinal estimators. We find that the provision of health insurance has influenced wage inequality. Finally, our results suggest there have been substantial changes in how displaced workers sort to firms that offer health insurance benefits over the past two decades. We discuss the implications of our findings for the compensating differentials literature.

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1. Introduction

Without a national health insurance system most Americans receive health benefits from their employers. As recent years have been characterized by rapid inflation in health care costs and

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health insurance premiums,¹ there are increasing reports that employers have either reduced or even stopped offering coverage, increasing the ranks of the uninsured.² In aggregate, the percentage of workers with employment-based health insurance has dropped from 70.0% in 1987 to 59.8% in 2004.

Economists generally argue that profit maximizing employers would respond to the costs associated with the provision of health insurance by reducing wages, thus maintaining the total reward paid to the employees. Whether employers truly adjust wages for the provision of health insurance is a long-standing question in health economics. Evidence of a wage/fringe benefit trade-off has been difficult to establish empirically, in part because jobs that offer health insurance may differ substantially from those where this benefit is not provided.³ Empirical researchers have traditionally attempted to answer this question using wage regressions. Researchers arrive at conclusions by examining the sign and significance of the estimated coefficient on the health insurance receipt variable. Studies generally differ in the source of variation used to identify health insurance receipt in these regressions. The early literature on this topic typically did not explicitly contain a discussion of the source of variation in the health insurance variable and researchers implicitly assume that employees have implicitly made these choices when accepting a job offer. Using cross-sectional data researchers typically recover wrong-signed estimates of the compensating wage differential particularly if they ignore the inherent endogeneity of health insurance receipt. Longitudinal data that explicitly account for individual specific permanent unobserved heterogeneity have also been used, yet results from these studies also do not support the theoretical prediction of a significant negative compensating differential.⁴ To identify the trade-off, many of these studies must overcome the endogeneity of job switching. In particular, if job lock is an important factor in the labor market, then the sample used in the analysis for identification will disproportionately contain those individuals who do not feel locked into their job, possibly attributable to a lower valuation of health insurance. To overcome this empirical challenge, *Simon (2001)* uses panel data on displaced workers who switch jobs for exogenous reasons, but also fails to find evidence of compensating wage differentials, which she attributes to difficulty in empirically dealing with the heterogeneity of job-skill matching.

In contrast, a recent literature attempts to use a credible source of variation in the costs of health insurance, which is arguably exogenous to workers employment decisions, to identify whether these additional costs are borne by workers. These studies generally find evidence consistent with

¹ Between 2001 and 2004, premiums for family coverage shot up by 59%, compared to a 9.7% gain in inflation and a 12.3% wage growth rate. See Kaiser Family Foundation and Health Research and Educational Trust (2004) for details.

² The Kaiser Family Foundation (2005) reports that only 60% of companies offered health insurance to their employees in 2005, down from 69% in 2000. *Gruber and McKnight (2003)* report that, in 1982, 44% of those who were covered by their employer-provided health insurance had their costs fully financed by their employer, but by 1998 this had fallen to 28%. *Cutler (2002)* finds that the increasing employee costs for health insurance resulted in employees declining coverage in the 1990s. Increased anecdotal evidence suggests that this trade-off exists, and there are reports in the popular press that firms have even made termination decisions based strictly on an individual's health behavior, such as smoking, in an effort to reduce health insurance costs (*Armour, 2005*).

³ *Bundorf (2002)* shows that higher wage workers are more likely to receive health insurance benefits. *Gruber and Lettau (2004)* find that the decision to offer health insurance at the firm level depends on the prices faced by both the median worker and highly compensated workers. *Wiatrowski (1995)* reports that medium and large establishments were 20% more likely to offer health insurance to full time employees relative to small establishments. *Dranove et al. (2000)* show that spousal coverage affects employment decisions.

⁴ *Currie and Madrian (1999)* present a survey of the early cross sectional and longitudinal compensating differential studies in the health economics literature. They conclude that many of these studies did not have the appropriate data to estimate the magnitude of the compensating differential.

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