Statement of the Honorable Mark J. Warshawsky, Ph.D. to the Senate Budget Committee, Hearing on "Assessing Inequality, Mobility and Opportunity" February 9, 2012

"What's Really Driving Inequality"

Chairman Conrad, Ranking Member Sessions, and Members of the Committee, I appreciate the opportunity to share my research findings and other information with you on the recent trends and causes of earnings inequality. I formerly was Assistant Secretary for Economic Policy at the Treasury Department where, among other activities, I followed developments in the labor market. I am currently a Member of the Social Security Advisory Board, and it was through this position that I gained access to unpublished detailed data from the Social Security Administration (SSA) and the Bureau of Labor Statistics (BLS) on the distribution of earnings and employee benefits. I used this data to conduct the research which is the content of my statement today. The research was published in an article appearing this past week in the Bloomberg BNA Pensions and Benefits Daily Reporter; I attach a copy of that article to this testimony.[1] I am not today representing the Advisory Board or any other government or private organization; rather I am only stating the research findings in the article and my own understanding of their analytical significance and policy relevance.

There is a large misunderstanding in the public on the difference between earnings and compensation.

A major theme reflected in recent government policies and politics and media coverage is a great concern with the perceived increased inequality of the distribution of resources in the United States over the last few decades. This phenomenon is usually measured in terms of household income or worker earnings. By these measures, inequality appears to have increased.

This limited view of the data has launched any number of redistributionist policies and proposals, especially focused on tax and the entitlement programs. Here I argue that there has been a fundamental misdiagnosis and inaccurate measurement of the problem. What many analyses ignore or downplay are the insidious effects on earnings of rapidly growing costs of health care benefits.

Using some standard economic assumptions, if the costs of employer-provided health benefits are growing at a faster rate than total compensation, then take-home earnings – compensation less the cost of health and other benefits – must grow slower for those at the lowest levels of compensation than for those at the highest levels. This simple math means that the inequality

[1] Mark J. Warshawsky, "Can the Rapid Growth in the Cost of Employer-Provided Health Benefits Explain the Observed Increase in Earnings Inequality?" Bloomberg BNA Pensions and Benefits Daily, 22, February 3, 2012, pp. 1 – 9; reproduced with permission from the Bureau of National Affairs.

of earnings would increase with fast-growing health care costs. This would be true even while the overall distribution of compensation and inequality measured according to compensation remains essentially unchanged.

The rapid growth in the cost of health care in the United States is widely noted. It is correctly said to cause burgeoning government spending and deficits, slower overall growth in worker earnings (wages), and later retirements. Less noted and understood is the tie of growth in health care costs to an increase in earnings inequality. The simple logic is as follows. Let's say that compensation (which is made up of earnings and benefits) grows at a certain common rate across workers over time at all compensation levels owing to, say, overall labor productivity improvements and that the market for labor services is competitive.

Let's also posit that health care benefit costs are the same dollar amount per worker at any point in time regardless of the worker's level of compensation and are evenly and widely provided to workers, or at least the distribution of prevalence and cost by compensation level has not changed much over time. But let's also say that health benefit costs are growing at a faster rate than compensation. Then earnings (which equal compensation less the cost of health and other benefits) must grow slower for those at the lowest levels of compensation than for those at the highest levels of compensation.

Data and studies support the hypothesis that the rapid increase in health costs leads to an increase in earnings inequality but no change in compensation inequality.

Statistics from the SSA and BLS strongly support this view. From 1999 to 2006, average hourly earnings increased about 29 percent. But hourly compensation, which also includes the cost of benefits, increased more quickly, about a 32 percent increase. This growth differential is explained mainly by the fact that the cost of benefits increased at a much faster pace than compensation—health insurance in particular increased almost 74 percent! And a study by a BLS economist found no change between 1997 and 2007 in the fraction of jobs (.789) with positive health insurance costs to the employer, that is, jobs for which the employer made some contribution toward employees' health insurance coverage.

That there was little change in employee access despite the large increase in employer cost makes sense because nondiscrimination rules in the tax code prevent an employer from favoring the higher-paid group in its workforce with tax-advantaged benefits. Also employers desire to avoid adverse selection in their health plans and, therefore, want to encourage younger, healthier workers (who generally are lower paid) to enroll. Currently the average employer cost of family health insurance coverage for workers is over $10,000 a year, a truly large amount of money.

As a share of compensation, on average across all workers, health insurance rose from 5.8 to 7.6 percent. Looking across the earnings distribution, according to the BLS data, the share of compensation going to health benefits increased notably from 1999 to 2006 especially for those in the lower and middle earnings percentiles. The growth in share was highest for the 30th percentile (low-earning full-time workers), from 6.5% to 12.2%, and was also high for the 60th percentile (middle-income workers), from 6.8% to 11.1%. At the 99th percentile (high income workers), by contrast, the health share in compensation moved only from 4% to 4.3%.

The cost of health care essentially drove an ever widening wedge between the growth of take home earnings and compensation. That is indeed exactly found in the data—earnings grew over 1999-2006 around 27 percent in the 30th to 60th percentiles, about 30 percent in the 80th to 90th percentiles, and about 35 percent in the 95th and 99th percentiles. But compensation growth, at around 35 percent, was essentially evenly distributed across all earnings levels; in fact, it grew the fastest in the lowest decile, at 41 percent, and at the same average rate in the highest percentile, at 36 percent.

Moving from dry statistics to perhaps more understandable job categories, consider the following results from the BLS on how the cost of health insurance may impact middle-income workers to a greater extent than upper-income workers. In 2006, workers in public elementary and secondary schools were paid $29.80 per hour and their health insurance cost $4.37 per hour, or 11.3 percent of compensation, while management workers in private industry were paid $41.43 per hour and their health insurance cost $3.05 per hour, or 6.1 percent of compensation. Even if the rate of growth in compensation was equal across these different job types and earnings levels, a higher rate of health care cost growth would mean that the higher-paid worker, the manager in private industry, would have more rapid growth in earnings than the middle-income worker, the schoolteacher. Indeed, according to a 2008 study by the Kaiser Foundation using BLS data, the percentage increases in the health insurance cost share from 1999 to 2005 were larger for low-compensation occupations than for high-compensation jobs.

Because the rapid increase in the cost of health insurance is a prominent long-run feature of the economic environment for the last fifty years, it likely has played an important role in the longer-term trends in earnings inequality as well. Several other studies indeed find this link over longer time periods.

There are important policy implications of these research findings.

Because total compensation growth has been essentially the same across earnings groups, the handwringing over inequality has largely been shooting at the wrong target. Either we are satisfied that we are getting value for the rapid increase in spending on health care, and there is no inequality problem because compensation is growing evenly, or we are concerned that we are not getting value, and the poor and middle-class workers are particularly bearing the dead-weight loss. In the latter case, this suggests that the most effective policy tool to address perceived inequality would be to slow the rate of growth of health care costs in the economy. In this regard, the Affordable Care Act is likely, on net, to make matters worse.

There are several recent examples in which rising earnings and income inequality have influenced policy proposals and legislative outcomes. In the 2010 budget document presented in February 2009 by the then-incoming Obama administration, the increasing income share of the top percentile of earners from 1980 through 2008 was shown prominently as a graph. The budget document ascribes the cause of increasing inequality to "technological advances and growing global competition."

Acting on the view that public policy needs to overcome this trend, the administration has consistently proposed letting the 2003 tax cuts for upper-income earners (defined as $200,000 for single taxpayers and $250,000 for joint filers) expire, and to limit the deductions and credits that may be taken by these earners. These proposals have not been enacted. In the health care reform legislation of 2010, however, an extra 0.9 percent payroll tax was placed on earnings in excess of $200,000/$250,000 of the taxpaying unit, and unearned income became subject to an extra 3.8 percent tax. These earnings triggers are not indexed for inflation and are being used to finance the expansion of health care subsidies mainly to lower-income workers. The overall mechanism is clearly intended to lessen income inequality.

Another area of public policy in which the issue of income inequality enters is Social Security reform. In 2010, two bipartisan deficit reduction commissions recommended, along with other provisions reducing scheduled benefits, that the maximum level of earnings taxable at the Social Security payroll tax rate (12.4 percent) be raised from $106,800 currently (in 2011) to about $200,000 (in today's dollars) ultimately.

The motivation for the proposal is to have Social Security be financed by 90 percent of total wages; this has been deemed a policy goal, presumably on fairness grounds. As my testimony in 2011 to the House Ways and Means Subcommittee on Social Security showed, this increase would mean that about 99 percent of workers would have all of their wages taxed by Social Security, as opposed to the historical norm of 94 percent of workers. Moreover, according to SSA statistics, the workers in the earnings range of $106,800 to $200,000 in 2009 actually saw their share of total wages decline slightly from 1990, while workers in the top fractiles got big increases in earnings over that time period. Even over the shorter period 1999 to 2006, workers with earnings above the 95th percentile but below the 99th percentile threshold got relatively small increases in earnings shares compared with the top percentile and fractiles.

In any case, this and the other proposals and legislated policies apparently do not consider a more relevant measure of well-being and economic capacity—total compensation and the trends pertaining thereto. As discussed earlier, this measure of inequality has not worsened. Even assuming that earnings, and not compensation, inequality is the most relevant policy and political measure, the empirical results in my paper indicate that the most effective policy tool to use in response would be to slow the rate of growth of health care costs in the economy.

Slowing the growth in health care costs is admittedly a challenging structural and political problem but that just argues for still more policy effort and political courage there. Just treating the symptoms of the inequality problem with tax and entitlement policies will have harmful side effects on overall economic growth and lose the opportunity to control budget deficits by lowering health care costs.

Members of the Committee, thank you for your kind attention to my statement. I am now glad to answer your questions.