For many people, when they get a raise they are surprised by how little of it actually shows up in their paycheck.  Where does this money go?? Consider the example below.  Suppose Suzy earns $4,000 a month in gross pay, and is paid on a monthly basis.  She doesn't receive $4,000 a month of course, because $4,000 is her gross pay, or the total amount she's earned before everything is taken out of her check.  Her paycheck will include her net pay, which is the total amount she takes home.  What is taken out of her gross pay?

1) Federal income taxes

2) State income taxes (if living in a state that collects income taxes, since not all states do)

3) Contributions to retirement savings plans

4) Contribution to employer's health insurance plan

5) FICA taxes, which are Suzy's contributions to the Social Security and Medicare taxes

Let's look at 4) and 5) in more detail. Suppose out of Suzy's $4,000 in gross pay, she pays $380 in federal and state income taxes. She did not contribute to her retirement plan.

FICA taxes: The federal government requires almost all workers to pay 6.2% of their gross pay to the Social Security trust fund and 1.45% of their gross pay to the Medicare trust fund.  Since these are "pay-as-you-go" federal programs, workers pay into the programs now and the people who are elderly now receive the benefits from the programs.  What many people do not know is that *employers are also required to pay the FICA taxes* on their employee's gross pay.  Let's look at Suzy's situation before and after her employer decided to reward Suzy for her productive work:

(A) Before having health insurance, Suzy was uninsured. Out of her $4,000 in monthly gross pay, she paid $380 in federal and state income taxes. She also paid ($4,000 x 0.062) towards Social Security and ($4,000 x 0.0145) towards Medicare, which is $248 and $58, respectively.  Therefore Suzy was left with ($4,000 - 380 - 248 - 58) = $3,314 per month.  Her employer also paid FICA taxes at the same rates as Suzy.  For Social Security, Suzy's employer takes $248 out of Suzy's check and $248 out of the employer's own funds and sends $496 to the Social Security trust fund (for a total of 12.4% of Suzy's gross pay).  Likewise the employer takes $58 out of Suzy's gross pay and $58 out of the employer's own funds and sends $116 to the Medicare trust fund (for a total of 2.9% of Suzy's gross pay).

(B) Now suppose the employer is deciding whether to give Suzy a $300 monthly raise or to offer Suzy health insurance benefits and pay $300 towards Suzy's health insurance premiums.  If Suzy goes on her employer's health insurance plan she would have to pay $100 in health insurance premiums per month.

  IMPORTANT! Federal law says that Suzy's $100 payment towards health insurance would come out of pre-tax income, not after-tax income.  That is, Suzy's taxable income per month would be reduced from $4,000 to $3,900, and her federal and state income taxes, and FICA taxes, would be based on her $3,900 gross pay. ALSO! The employer's $300 contribution to Suzy's health insurance plan is non-taxable; meaning the employer does not have to pay FICA taxes on this contribution.  If Suzy's employer gives Suzy a $300 raise, the employer will have to pay FICA taxes on that additional $300. The table below shows the different outcomes from either giving Suzy the $300 raise or paying $300 towards Suzy's health insurance premium.

|  |  |  |
| --- | --- | --- |
|  | **Suzy with $300 raise** | **Suzy with employer-sponsored contribution of $300 to health insurance premium** |
| **Gross Pay** | $4,300 | $4,000 |
| Employer’s health insurance contribution | $0 | $300 |
| **Suzy’s health insurance contribution** | $0 | $100 |
| Taxable income | $4,300 | $3,900 |
| **Federal and state income taxes** | $410 | $368 |
| FICA taxes | (4,300 x 0.062) + (4,300 x 0.0145) = $329 | (3,900 x 0.062) + (3,900 x 0.0145) = $298 |
| **Net Pay to Suzy** | $3,561 | $3,234 |
| Difference from previous net pay of $3,314 | ($3,561 – 3,314) = $247 | ($3,234 – 3,314) = -$80 |
| **Employer’s contribution to FICA taxes** | (4,300 x 0.062) + (4,300 x 0.0145) = $329 | (3,900 x 0.062) + (3,900 x 0.0145) = $298 |

**Questions:**

1)  If Suzy could choose between the $300 raise and the $300 contribution, what factors do you think would influence her choice?

2) Some politicians would like to get rid of the tax-exemption that employers receive on contributions to employer-sponsored health insurance plans.  If that occurred, Suzy's employer would have to pay FICA taxes on the $300 contribution to Suzy's health insurance premium, whereas now the employer does not.  If that occurred, what do you think would happen to employers' willingness to offer health insurance plans to their employees?

3) Suzy also benefits from the decrease in her taxable income from her health insurance contribution. Think of all employees who participate in their employer's health insurance plan and receive this type of benefit.  What demographic features describe those employees who most value being able to reduce their taxable income by making contributions to their employer-sponsored health insurance plan; young, old, rich, poor, males, females? Give at least two demographic features of those employees who most benefit and describe why you think they benefit.