EBRI ISSUE BRIEF

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EMPLOYEE BENEFITS: TRENDS, EQUITY, AND FEDERAL REVENUE IMPLICATIONS

ABSTRACT

For several years the growth of employee benefits as a form of tax-favored compensation has been a central concern in the debate over federal tax policy. In February and March 1984, the tax-writing committees in the House and Senate again focused on the favorable tax treatment of employee benefits. Many who are concerned about the federal deficit, and many observers of Social Security's financing problems, interpret the growth of tax-favored employee benefits as an erosion of the tax base and as a threat to the government's ability to maintain services and honor past commitments.

The emergence of new forms of tax-favored employee benefits -- such as deferred compensation plans and cafeteria plans in particular -- alarms those who view the growth of employee benefits only as erosion of the tax base. Yet, this appraisal of employee benefits is one-sided.

Tax expenditures for employee benefits must be evaluated in terms of the resulting social benefits. The emergence of new forms of employee benefits actually represents employer efforts to reduce the growth of benefit costs. The growth of some new types of benefits may represent a net addition to the Social Security payroll tax base, if they substitute for the growth of more traditional benefits not subject to payroll taxes. To design efficient long-run public policy, the growth and redefinition of tax-favored employee benefits must be evaluated in a broader, more sophisticated context. This Issue Brief reviews some of the basic questions of concern to Congress and to everyone interested in the future of employee benefits. It reviews how tax-favored employee benefits have evolved; and where they are going; how important these benefits are to workers at different income levels; and the reason tax expenditures associated with employee benefits should be evaluated in terms of the public policy goals served.

Introduction

Concern about the so-called tax expenditures--or losses of federal tax revenues to the U.S. Treasury--from tax-favored treatment of employee benefits has been a persistent concern of policymakers in the last few years. Most recently in late February and early March 1984, the issue again received prominent attention by the tax-writing committees of the Senate and the House of Representatives. The February 10, 1984, Internal Revenue Service news release which declared "invalid" certain reimbursement and flexible spending arrangements,1/ triggered discussion of tax-favored employee benefits during a House Ways and Means Committee February 28 hearing on tax shelter abuses. Although the specific proposals discussed at the hearing focused principally on voluntary employees' beneficiary associations (VEBAs) and flexible compensation or "cafeteria" plans, the exchange between the Members of the Committee and the witnesses spilled over into the whole field of employee benefits and their preferred treatment within the tax code.

Representative J. J. Pickle (D-TX) said that flexible benefit plans are a very serious matter for Congress.2/ Representative Pickle also said that he did not know whether Congress would consider cafeteria plans in a tax bill this year, but that something would have to be done about plan abuses. The Ways and Means Committee Mr. Pickle said, cannot allow the continued erosion of the tax base; he suggested that it might be helpful if Ways and Means had some estimates on the costs of cafeteria plans. Alicia H. Munnell, a vice president and economist for the Federal Reserve Bank of Boston, and a witness at the February 28 hearing, went even further.3/ She stated that the most workable approach for salvaging the income and payroll tax bases, as they pertain to employer-provided fringe benefits, is to establish a limit on the proportion of total compensation that an employee can receive tax free.

The debate at the House Ways and Means Committee hearing was replayed later in the Senate Finance Committee, during the March markup of the federal deficit reduction package in March. Senator John Danforth (R-MO), who at one of the markup sessions suggested he might offer an amendment striking the Section 125 cafeteria provisions from the tax code altogether, later offered an amendment that would bar cafeteria benefit plans from offering more than $3,000 in annual tax-free benefits per participant. The proposal would also prevent cafeteria plans from offering nonstatutory benefits, such as extra vacation days, as options. In addition, cafeteria plans could not have included deferred-compensation benefits, like 401 (k) salary reduction plans, as part of their package. Senator Danforth said: "We have stacked the deck in favor of fringe benefits" by giving them tax-free status.4/ Danforth later withdrew his

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1/ The full text of the IRS press release can be found in EBRI Notes, vol. 5, no. 1 (January/February 1984): 3-4.

2/ BNA Pension Reporter, March 5, 1984, p. 288.

3/ The substance of her testimony was incorporated in "Employee Benefits and the Tax Base," New England Economic Review, January/February 1984, pp. 39-55.

4/ Quoted by Jerry Geisel, "Move to limit cafeteria benefits fails," Business Insurance, March 19, 1984, p. 28.

amendment when it became apparent that he would not succeed in mustering the support of a majority of the Finance Committee Members.

Veteran Capitol Hill observers have noted that even though the tax-writing committees have thus far decided not to severely restrict cafeteria and other tax-favored benefits during this election year, 1985 will almost certainly witness renewed and more intensified legislative efforts in this area.

With this intense legislative interest as background, it is important that policymakers understand the different roles played by the various types of employee benefits--both the traditional benefits like pensions and health, and the newer forms of benefits--like Section 401 (k) salary reduction and Section 125 cafeteria plans. Some basic questions have to be posed--and answered; questions such as what are employee benefits, what have they evolved from, where are they going, and how important are they to workers. This Issue Brief reviews some basic questions of concern to Congress--and to everyone interested in the future of employee benefits. It reviews how tax-favored employee benefits have evolved; and where they are going; how important these benefits are to workers at different income levels; and the reason tax expenditures associated with employee benefits should be evaluated in terms of the public policy goals served.

Growth of Employee Benefits

Employee benefits serve a number of purposes. Pensions, profit-sharing plans, and employee thrift plans provide for deferral of income and encourage private saving for retirement. Health benefits, disability income plans, life insurance, and supplemental unemployment benefits provide insurance protection against unanticipated, catastrophic events. Some programs provide for consumption; these include day care benefits and, sometimes, routine dental and vision care benefits. Many of these benefits, together with employee vacation time and rest periods, are intended to raise employee productivity, reduce time lost from work, and build positive employee relations.

Expanded employer pension and welfare plans over the past thirty years have significantly improved the income security of current workers and future retirees. Growth of employer group health insurance coverage among workers and their dependents has promoted wide access to health care throughout the nonelderly population. These achievements are, in part, a response to tax incentives.

The growth of employee benefits as a form of employee compensation has attracted increasing attention in recent years chiefly because of a concern that the growth of benefits occurs at the expense of growth in wage and salary income. Slower growth of wages and salaries, in turn, implies slower growth of the tax base. Erosion of the tax base affects the public sector's ability to finance government programs in general and the Social Security system in particular. In addition, growth of nontaxable benefits may generate an important redistribution of the tax burden across the population. These effects of growth in employee benefits, and in tax-exempt benefits in particular, merit careful attention.

For purposes of analysis, employee benefits can be classified into three categories:

- o legally required benefits (including employer contributions to Social Security, unemployment insurance and workers' compensation insurance);
- o discretionary benefits that are fully taxable (primarily, payment for time not worked); and
- o discretionary benefits that are tax-favored (including employer contributions to pension and health insurance plans).

Discretionary employer contributions to tax-favored benefits--those that are not taxed as current income to the employee--can be further subdivided into two groups: benefits on which taxes are deferred and benefits that are tax exempt.

- o Tax-deferred benefits primarily include employer contributions to retirement income and capital accumulation plans. Taxation of these benefits is deferred until the employee withdraws funds from the plan.
- o Tax-exempt benefits include employer contributions to group health insurance and a variety of smaller benefits that include dental insurance, child care, merchandise discounts, and employer-provided meals.

Discretionary tax-favored employee benefits represent about 28 percent of all employee benefits and 9 percent of wages and salaries. Since 1950, tax-favored employee benefits as a share of compensation (table 1) have grown at an average annual rate of 4.4 percent, compared to somewhat slower growth of legally required benefits and of taxable discretionary benefits.

Employer contributions to group health insurance are the fastest-growing component of employee benefits. The expansion of worker and dependents' coverage under employer group plans, the enhancement of benefits under these plans, and persistent high inflation in health care costs have all contributed to the growth of employer contributions to health insurance as a share of compensation. Between 1950 and 1980, employer health insurance contributions as a percent of total compensation have risen at an average annual rate of 6.3 percent. Reflecting continued high inflation in health care costs since 1980, employer contributions to health insurance have continued to grow at an average annual rate of 6.1 percent more than the growth of compensation.

Failure to distinguish among the growth of legally required employer payments, fully taxable employee benefits, tax-deferred benefits, and tax-exempt benefits has greatly distorted the perception of the tax-base erosion that can be attributed to tax-favored and tax-exempt benefits. This common misperception was highlighted by Secretary of the Treasury Donald

TABLE 1

Average Annual Growth Rates of Major Employee Benefits
as a Share of Total Compensation, 1950-1983

	Average Annual Rate of Growth (in percents)		
Employee Benefit	1950-1980	1970-1980	1980-1983
Total Benefits	2.5	1.8	2.2
Legally Required Benefits	2.6	2.1	3.0
Discretionary Fully Taxable Benefits[a]	1.4	1.2	1.2
Discretionary Tax-Favored Benefits	4.4	3.0	3.0
Government Pensions	2.1	0	0
Private Pensions and Profit-Sharing	4.9	4.5	1.9
Group Health	6.3	4.5	6.1
Group Life	2.3	-2.2	0

SOURCE: EBRI calculations based on U.S. Chamber of Commerce, Employee Benefits 1982 (Washington, D.C.: Chamber of Commerce, 1983).

a/ Vacation time and other time not worked. Calculations based on interpolations from Chamber of Commerce data for 1980 and 1982.

Regan; his May 22, 1983, statement to ABC News included the following comment:

> I think that when you look at the way our pension systems, our medical systems and the like are. . . running at full throttle, and are increasing year after year, that sooner or later they're going to have to be slowed down or else we'll never get these deficits under control.

TABLE 2

Discretionary Tax-Favored Employee Benefits by Specific Tax Treatment, 1982

Tax Status/ Benefit Group	Employer Contributions as a Percentage of Wages and Salaries	Employer Contributions as a Percentage of All Benefits	Employer Contributions as a Percentage of Tax-Favored Benefits
All Tax-Favored Benefits	9.0	27.7	100.0
Tax-Deferred Benefits:	4.5	13.8	49.5
Pension and Profit-Sharing Plans a/	4.0	12.3	44.0
Short- and Long-Term Disability Insurance b/	0.3	0.9	3.3
Other Tax-Deferred Benefits c/	0.2	0.6	2.2
Tax-Exempt Benefits:	4.6	14.2	50.5
Contributions to group health and life insurance d/	4.1	12.6	45.1
Other tax-exempt benefits e/	0.5	1.5	5.5

SOURCE: EBRI tabulations of U.S. Chamber of Commerce estimates in Employee Benefits 1982 (Washington, D.C.: U.S. Chamber of Commerce, 1983), pp. 11 and 28.

NOTE: Figures may not add to total because of rounding.

a/ Includes EBRI estimate of employer contributions to profit-sharing plans based on Chamber of Commerce figures.
b/ EBRI estimate based on Chamber of Commerce figures.
c/ Includes EBRI estimate of employer contributions to employee thrift plans based on Chamber of Commerce figures.
d/ Estimate includes fully taxable employer payments for life insurance in excess of $50,000.
e/ EBRI estimate of discounts on merchandise, meals furnished by company, payments for vision care and prescription drugs, and moving expenses, based on Chamber of Commerce figures.

The size of tax-favored benefits as a proportion of wages and salaries, however, is much smaller than such statements suggest. Table 2 summarizes the distribution of discretionary tax-favored benefits by tax-deferred and tax-exempt status. In 1982, tax-deferred benefits constituted about 4.5 percent of wages and salaries, tax-exempt benefits constituted 4.6 percent.

Tax Preferences and Federal Revenue Losses

Private retirement program tax expenditures form the single largest category of tax expenditures in the federal budget. They arise from the

TABLE 3

Employer Benefit Tax Expenditures in the Administration's Budget by Budget Function, Fiscal Years 1983-1985 (In millions of dollars) a/

Provision	1983	1984	1985
Commerce and Housing Credit:			
Exclusion of interest on life insurance savings	$4,335	$4,720	$5,180
Education, Training, Employment, and Social Services:			
Employer educational assistance	40	20	--
Exclusion of employer provided child care	20	40	70
Exclusion of employee meals and lodging (other than military)	680	725	795
Exclusion of contributions to prepaid legal services plans	40	40	45
Investment credit for ESOPs	1,250	1,375	1,875
Health:			
Exclusion of employer contributions for medical insurance premiums and medical care	15,270	17,625	20,165
Social Security and Medicare:			
Exclusion of Social Security benefits:			
OASI benefits for retired workers	14,035	13,895	12,975
Benefits for dependents and survivors	3,775	3,755	3,765
Disability insurance benefits	1,310	1,225	1,105
Income Security:			
Exclusion of railroad retirement system benefits	780	615	450
Exclusion of workman's compensation benefits	1,885	2,020	2,215
Exclusion of special benefits for disabled coal miners	160	155	155
Exclusion of untaxed unemployment insurance benefits	2,960	2,305	1,800
Exclusion of disability pay	120	75	--
Net exclusion of pension contributions and earnings:			
Employer plans	46,585	50,535	56,340
Individual Retirement Accounts	8,855	9,190	9,840
Keoghs	1,460	1,475	1,530
Exclusion of other employee benefits:			
Premiums on group term life insurance	2,040	2,170	2,380
Premiums on accident and disability insurance	120	120	125
Income of trusts to finance supplementary unemployment benefits	20	20	20
Veterans benefits and services:			
Exclusion of veterans disability compensation	1,815	1,810	1,855
Exclusion of veterans pensions	345	335	340
Total	107,950	114,295	123,125

SOURCE: Special Analysis G, Budget of the United States Government, Fiscal Year 1985.

a/ Budget functions are groups of federal programs or activities that address a common national need. There are 18 budget functions.

deferral of taxes paid on: (1) pension and retirement saving contributions; and (2) earnings on these contributions. Tax deferral of pension and retirement saving contributions represents deferral of current revenue; taxes are paid on withdrawals from the funds after the worker retires. In a lifetime context, however, gross federal revenue losses are significantly lower than current revenue deferrals. As much as 75 percent of the real (i.e., inflation-adjusted) value of taxes deferred during pension participants' working careers is ultimately repaid in retirement income taxes.5/

Employer contributions to group health insurance are the fourth largest tax expenditure in the 1985 budget. These contributions are exempt from Social Security, corporate income and individual income taxation.

Tax expenditure estimates are a poor guide for setting either federal tax policy or federal retirement or health policy.6/ Nevertheless, the high tax expenditure estimates for pension and group health insurance plans continue to attract public attention and critical appraisal of these plans' tax-favored status. Measurement of current versus lifetime tax revenue losses, however, is only part of the task of evaluating tax preferences for employer pension contributions, retirement saving, and employer-sponsored health insurance. The benefits to society that derive from tax preferences for these plans must also be appraised. Tax laws favoring employer retirement and health insurance plans were enacted under the premise that broad coverage of workers and their dependents under these plans is desirable social policy.

Worker Participation in Tax-Favored Employee Benefits

Between 1950 and 1979, the rate of worker participation in employer pensions grew by 23 percent; in absolute numbers, employee pension participation rose by 263 percent.7/ Econometric estimates suggest that, since 1960, 20 to 30 percent of the increase in employer pension contributions as a share of compensation can be attributed to favorable tax incentives and the growth of real marginal tax rates.8/

5/ Sophie Korczyk, Retirement Security and Tax Policy (Washington, D.C.: Employee Benefit Research Institute, forthcoming). These simulation results are consistent with calculations for hypothetical workers reported by Richard A. Ippolito, "Public Policy Towards Private Pensions" Contemporary Policy Issues, 3 (April 1983): 53-76.

6/ See: Deborah Chollet, "Background on the Tax Treatment of Employee Benefits: An Overview of the Issues" in Dallas L. Salisbury, ed., Why Tax Employee Benefits? (Washington, D.C.: Employee Benefit Research Institute, 1984).

7/ Sylvester J. Schieber and Patricia M. George, Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement (Washington, D.C.: Employee Benefit Research Institute, 1981), pp. 54-55.

8/ Korczyk, Retirement Security and Tax Policy.

Data collected by household and insurer surveys indicate that insurance coverage for major health care expenses, and access to health care services, has risen steadily among the U.S. population since 1960. In 1979, nearly 61 percent of the U.S. population received health insurance coverage from an employer group health plan. Among all persons with private health insurance coverage in 1979, at least 83 percent were covered by an employer plan.9/ Recent congressional concern over lack of health insurance among unemployed workers and their families suggests that Congress continues to perceive high rates of private health insurance coverage as a public policy goal.

The removal of tax preferences for employer health insurance contributions might dramatically reduce rates of coverage among low-income workers and their families, among workers and their dependents who experience unemployment during the year, and among persons who are eligible for Medicaid or Medicare coverage.10/ An EBRI simulation of the probable pattern of coverage loss suggests that tax preferences for employer health insurance contributions strongly benefit low-income workers and their dependents, provide important economic security for workers with fragmented employment histories, and reduce the public cost of health care entitlement programs.11/

The tax deferral of employer pension contributions and individual retirement saving provides important incentives for employers and workers to provide for retirement income. The increasing importance of pensions as a source of income projected among future retirees is the direct result of past growth in pension plan participation among workers. The projected rate of pension recipiency among today's young workers (ages twenty-five to thirty-four) is nearly twice that of workers who are retiring today (see table 4).

In sum, tax preferences for employer health and pension contributions and individual saving for retirement are a critical factor in determining worker participation and coverage. Nondiscrimination provisions in the tax code make tax benefits contingent on the breadth of the plan's coverage, that is, both high- and low-income workers must be included in tax-qualified plans.

Who Benefits?

Partly because of tax incentives, participation in employer pension and health insurance plans is high. In 1979, 48 percent of the total work force participated in an employer pension plan; 74 percent were covered by an employer group health insurance plan. Among full-time, full-year workers,

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9/ EBRI tabulations of the March 1980 Current Population Survey (U.S. Department of Commerce, Bureau of the Census).

10/ Deborah Chollet, Employer-Provided Health Benefits: Coverage, Provisions and Policy Issues (Washington, D.C.: Employee Benefit Research Institute, 1984).

11/ Ibid.

TABLE 4

Estimated Percentages of Families
Receiving Pension Benefits at Age Sixty-Five, and Average
Real Benefits, by Current Age and Marital Status

	All Families		Married Couples		Single Persons	
Cohort Age in 1979	Percentage to Receive Benefit	Average Amount of Benefit a/	Percentage to Receive Benefit	Average Amount of Benefit a/	Percentage to Receive Benefit	Average Amount of Benefit a/
25-34	71	$12,417	75	$14,541	65	$8,701
35-44	65	11,190	67	12,563	60	8,823
45-54	52	8,656	58	9,621	41	6,496
55-64	37	5,315	44	5,548	26	4,718

SOURCE: Social Security: Perspectives on Preserving the System (Washington, D.C.: Employee Benefit Research Institute, 1982), p. 90.

a/ Real dollars are calculated using 1982 as the base year.

rates of coverage are much higher. In 1979, more than 74 percent of full-time full-year workers participated in an employer pension plan, and 89 percent were covered by an employer health plan.12/ Participation in tax-favored individual retirement saving plans is more modest. In 1982, 13 percent of all households that filed a federal income tax return reported participation in an individual retirement account (IRA).13/

Employee benefits are widely distributed among workers and their families at all income levels. Reflecting the concentration of workers at low and middle incomes, most workers who participate in employer pension and health

12/ Schieber and George, Coverage and Benefit Entitlement, pp. 38 and 54; and Chollet, Employer-Provided Health Benefits. Pension coverage rates for full-time full-year workers include only nonagricultural workers, age twenty-five to sixty-four, with one year of service and working more than half-time. Health insurance coverage rates include all full-time nonagricultural workers who worked fifty weeks or more during 1979.

13/ U.S. Department of the Treasury, Internal Revenue Service, "Selected Statistical Series, 1970-1983," Statistics of Income (SOI) Bulletin, 3 (Winter 1983-84): 62.

insurance plans are low- or middle-income workers. In 1979, 75 percent of all workers covered by an employer pension plan under ERISA standards, and 80 percent of all workers covered by an employer group health plan, earned less than $20,000 (see table 5). The distribution of employer health coverage by family income (reflecting the prevalence of multiple-earner households and dependents' coverage) shows a similar distribution. In 1979, 71 percent of all nonelderly persons (workers and their dependents) covered by an employer group health plan reported adjusted gross family income of less than $30,000. The median adjusted gross family income among persons covered by an employer group health plan in 1979 was less than $25,000 (see table 6).

The distribution of IRA savings among income groups also suggests the effectiveness and wide distribution of IRA tax advantages at every income level. In 1982, 18 percent of all IRA accounts, and 14 percent of all IRA contributions, were made by households with adjusted gross income less than $20,000. More than a third of all IRA contributions--34 percent--were made by households with adjusted gross income of less than $30,000.14/ In short, there is no evidence that tax preferences for employee benefits or private retirement savings favor only highly paid workers.

TABLE 5

Distribution of Employees with Pension and Health Coverage by Earnings, 1979

Earnings	Employees with Pension Coverage		Employees with Health Coverage	
	Total	Percent	Total	Percent
	(in millions)		(in millions)	
Less than $20,000	27.8	75.3	58.3	79.8
$20,000 to $49,999	8.7	23.7	13.9	19.1
$50,000 and over	0.3	0.9	0.8	1.1
Total a/	36.9	100.0	73.0	100.0

SOURCES: Pension distribution based on Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement (Washington, D.C.: Employee Benefit Research Institute, 1981). Health distribution from EBRI tabulation of the May 1980 Current Population Survey (U.S. Department of Commerce, Bureau of the Census).

a/ Figures may not sum to totals because of rounding.

14/ EBRI tabulations of Internal Revenue Service data for tax year 1982.

New Forms of Employee Benefits

The growth of new tax-favored employee benefits has alarmed those who see the emergence of these benefits simply as further erosion of the tax base. In fact, employers often have independent motivations for setting up

TABLE 6

Percent of Nonelderly Persons with
Employer Group Health Insurance Coverage
and with Employer Contributions to Coverage,
by Family Income, 1979

Adjusted Gross Family Income a/	Persons with Employer Group Coverage	Covered Persons with Employer Contribution	Persons with Employer Contribution	Distribution of All Persons with Employer Contribution
Loss b/	3.1	80.0	2.5	0.3
$ 1- 4,999	11.6	85.3	9.9	2.2
5,000- 7,499	34.5	88.7	30.6	3.2
7,500- 9,999	47.8	90.5	43.2	4.4
10,000-14,999	63.0	92.1	58.0	13.0
15,000-19,999	75.6	92.6	70.0	16.8
20,000-24,999	81.8	94.4	77.2	16.7
25,000-29,999	83.2	94.8	78.9	14.2
30,000-34,999	84.8	94.8	80.4	9.8
35,000-39,999	84.4	94.9	80.1	6.1
40,000-49,999	83.1	94.5	78.5	6.8
50,000-59,999	82.8	92.8	76.8	4.0
60,000-74,999	76.0	91.3	69.4	1.7
75,000 or over	74.4	86.0	63.9	0.6
Total, All Persons	60.0	93.1	56.4	100.0

SOURCE: EBRI tabulations of the March 1980 Current Population Survey (U.S. Department of Commerce, Bureau of the Census).

a/ Includes earnings, interest, dividends, other property income, and pension income. Excludes income from public insurance and transfer programs.

b/ Includes some persons reporting no income in 1979.

these plans. The growth of new benefits--in particular, Section 401(k) salary reduction plans and Section 125 cafeteria plans--generally represents an effort by employers to contain the cost of tax-favored employee benefits.

Rising employer pension costs have prompted several innovations in the design of retirement income plans. Section 401(k) plans, authorized by the Revenue Act of 1978, have become an increasingly popular tool for controlling employer pension costs. Employees are able to supplement employer contributions to a Section 401(k) plan with tax-deferred contributions of their own. This allows employers to contain their retirement plan costs. In general, Section 401(k) plans probably represent a net reduction in employer pension contributions relative to the level that would be required to ensure adequate retirement income with lower employee retirement saving.

Section 401(k) plans also reduce the employer's projected cost of indexing retirement benefits. Although pension benefit increases are seldom automatic, most employers provide _ad hoc_ cost-of-living adjustments for current retirees. Under current law, sponsors of defined-benefit pension plans cannot reserve funds against future _ad hoc_ cost-of-living increases, even in cases where the plan has a clear history of providing those increases. _Ad hoc_ increases, therefore, are funded from current contributions, or offset against actuarial gains, or added to the plan's unfunded liability.

Section 401(k) plans--and other defined contribution plans--represent a way to provide employees with some inflation protection in retirement, at substantially lower cost to employers. Defined contribution plans are automatically indexed, since the asset value of the plan generally rises with inflation. Inflation reserves, therefore, accumulate automatically.

Section 401(k) plans also meet the demand for retirement income security among mobile workers and workers with intermittent labor force participation. Employee contributions to Section 401(k) plans are, by law, fully and immediately vested. Short-tenure workers, therefore, may be better served by 401(k) plans than by more traditional plans. These workers, and workers with intermittent labor force participation, are protected because they can "roll over" the accumulated contributions and earnings of the plan into a tax-deferred individual retirement account. As a result, Section 401(k) plans may particularly benefit young workers with high labor-force mobility and women who may leave the labor force for protracted periods.

The growth of cafeteria (or Section 125) plans also reflects employers' efforts to control the cost of employee benefits. Generally, the primary motive of employers in establishing a cafeteria plan is the containment of employer contributions to health insurance. In fact, "mature" cafeteria plans can be characterized as those which have broken the automatic link between inflated health care costs and employer support for health insurance coverage. Cafeteria plans encourage employees to elect less generous health insurance coverage, and substitute other benefits--both tax-favored and fully taxable benefits--for generous health insurance coverage. Like Section 401(k) plans, cafeteria plans enable employers to meet the benefit needs of an increasingly diverse work force--including young workers and women--while controlling total benefits costs.

Cafeteria plans have emerged and matured despite the fact that regulations, or even detailed legislation, have not been provided. Alleged abuses in the design of some cafeteria plans have been dramatized by the recent news release from the Internal Revenue Service, declaring certain reimbursement accounts invalid. (Cafeteria plans may include a reimbursement account or flexible spending account; they are not synonymous with, or dependent on, flexible spending accounts.) Where the Congress believes abuses exist, limits or guidelines for the use of benefits within cafeteria plans probably will be set at some point. However, examples of possible abuses within cafeteria plans should not obscure the overall efficiency of these plans and their cost advantages for both employers and employees.

Revenue Implications of New Forms of Employee Benefits

Many observers of the emerging changes in employee benefit plans have claimed that the development of new forms of employee benefits merely represents further tax-base erosion. These claims, however, have often been made with little or no supporting evidence. There are several reasons to believe that the growth of nontraditional benefits--in particular, Section 401(k) plans and cafeteria plans--may actually reduce further erosion of the payroll and individual income tax bases.

While employer contributions to traditional pension plans are entirely tax-deferred, employee contributions to Section 401(k) plans are taxable by Social Security. Employers have favored Section 401(k) plans as a means of reducing the level of contributions they might have to make if they offered only a traditional pension plan. If the growth of Section 401(k) plans does, in fact, substitute for the growth of more traditional pension benefits, they would represent an addition to the current payroll tax base.

The growth of cafeteria plans also implies potential growth of the payroll and income tax bases. Cafeteria plans typically include a menu of taxable and tax-favored benefits. Cafeteria plans encourage employees to elect less generous health insurance coverage, and substitute spending for other benefits--both taxable and tax-favored--for tax-exempt health insurance spending. As a result, these plans do not necessarily represent erosion of the tax base.

Conclusion

Tax laws favoring specific employer retirement and health insurance plans were enacted under the premise that extensive coverage of workers and their dependents under these plans is desirable social policy. The growth of worker coverage by pensions and health insurance since 1950 has been strongly encouraged by the tax advantages accorded these plans, and by the growth of real marginal tax rates.

Employee benefits are widely distributed among workers and their families at all income levels. Like the labor force as a whole, most workers participating in employer pension and health insurance plans are low- and middle-income workers. In 1979, more than 75 percent of all workers covered by an employer pension plan under ERISA standards, and 80 percent of all workers covered by an employer group health plan, earned less than $20,000. Contrary to the perceptions of many, there is no evidence that tax preferences for employee benefits favor only highly paid workers.

The historic growth of private pension plan participation among workers, and the current growth of worker participation in Section 401(k) plans and IRAs represent private saving for retirement income. Considering the increasing cost of Social Security and the projected decline in the ratio of workers to retirees, private saving for adequate income replacement in retirement has emerged as a necessary and desirable public goal.

The emergence of nontraditional benefits warrants careful and balanced scrutiny. These benefits generally serve to balance the interests of employers seeking to contain benefits costs and the interests of employees, who demand a more diversified package of benefits than ever before. The new forms of employee benefits may serve best those workers whose needs are least adequately met by more traditional benefits--younger workers and employed parents. Further, the growth of nontraditional benefits may actually contribute to the payroll and income tax bases, to the extent that the new employee benefit forms substitute for traditional tax-exempt or fully tax-deferred benefits.

The Employee Benefit Research Institute's Education and Research Fund (EBRI) was established to contribute to the expansion of knowledge in the employee benefit field. The Education and Research Fund is tax exempt under section 501(c) (3) of the Internal Revenue Code and is not a private foundation. Individuals, corporations, companies, associations and foundations are eligible to support EBRI's work through tax-deductible contributions.

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