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Employee Benefits and the 1986 Reagan Budget

The Reagan administration's 1986 budget proposal represents essentially a holding action for employee benefits, as well as for most other domestic spending programs. Among retirement and other wage replacement plans, major changes are few. Social Security benefits grow automatically in the next two years due to increases in the number of beneficiaries and in the cost of living. Unemployment benefit payments are expected to decline due to improvement in the economy. In most programs cost-of-living adjustments would be frozen beginning in 1986.

Similarly, the administration proposes to freeze most spending for federal health, disability and safety programs. Medicare hospital reimbursements would be held at the 1985 level, and the existing freeze on Medicare payments to physicians would be extended. In addition, however, the administration proposes to increase enrollee premiums for Medicare Supplementary Medical Insurance (SMI) to cover a greater share of program costs. The administration also proposes to cap federal participation in Medicaid. Finally, by reviewing continued Social Security Disability Insurance (DI) eligibility, the administration proposes DI spending increases (2 percent) which are less than the anticipated cost-of-living increase in program benefits.

Two revenue-raising initiatives are proposed in programs related to regulation and enforcement of benefit-related statutes. An increase in the $2.60 per-participant insurance premium charged single-employer sponsors of defined benefit pension plans is again requested. This year the premium request has been increased to $7.50, up from last year's request of $7.00. The budget also proposes that determination letters and private letter rulings issued to plan sponsors by the Internal Revenue Service carry a user fee of $100.

The budget proposal is only part of the Reagan administration's agenda in fiscal and employee benefits policy for this year. The Treasury's tax reform proposal submitted to the president last year is the backdrop against which budget and tax debates will occur this year. Taken together, the budget and tax proposals could revolutionize the environment for employer-provided benefits.

◆ The Deficit and the Economy

The size of the federal deficit represents a central focus of the 1986 budget debate. The Congressional Budget Office (CBO) calculates that the deficit will rise to $215 billion in 1986 if projected federal receipts and expenditures remain unchanged. Under the administration's proposal, however, the Office of Management and Budget estimates a deficit of only $180 billion for 1986 (table 1). Some of the adverse long-run effects of large deficits may be high interest rates, heavy capital inflows from abroad, and structural imbalances in the economy. The Treasury bill rate forecast by CBO for 1986 under their higher deficit assumptions is well above that projected by the administration (table 1). Nevertheless, in the short run deficits have been credited with improving economic growth.

Many believe that the adverse affects of continued large federal deficits are only fully apparent in the long run. Such a long-run focus for budgetary action is unusual, although the 1986 debate may signal a trend toward a longer run perspective. In the longer run, CBO projects a 1990 deficit of $296 billion without change in current policy. Incorporating legislative policy changes, the administration presents a more optimistic estimate of $82 billion. In 1990, CBO projects a Treasury bill rate of 8.2 percent coupled with an inflation rate of 4.2 percent. By comparison, the administration forecasts show a 5.0 percent Treasury bill rate and an inflation rate of 3.3 percent.

In the long run, excessively high deficits are expected to lead to a reduction in investment and capital formation and slower economic growth. This will have obvious deleterious effects on income and consumption. If the money supply is expanded to meet the increased federal credit needs without raising interest rates, the economy could also be subject to increasing inflation.

While most agree that persistent large budget deficits will play havoc with the economy, the magnitude and timing of these effects are largely unknown. For this reason CBO and administration projections of the real Gross National Product

Table 1
Contrasting Projections of the Federal Deficit and Other Economic Indicators Calendar Years 1985–1990

	1985	1986	1987	1988	1989	1990
Total Federal Deficit (billions)						
Administration	$222	$180	$165	$144	$108	$ 82
Congressional Budget Office	$214	$215	$233	$249	$272	$296
91-Day Treasury Bill Rate (percent, annual average)						
Administration	8.1	7.9	7.2	5.9	5.1	5.0
Congressional Budget Office	8.4	8.7	8.3	8.2	8.2	8.2
Consumer Price Index (percentage change, year after year)						
Administration	4.1	4.3	4.2	3.9	3.6	3.3
Congressional Budget Office	3.7	4.4	4.3	4.2	4.2	4.2

Sources: Executive Office of the President, Office of Management and Budget, *The Budget of the United States Government, Fiscal Year 1986*, pp. 3–15 and 9–12; U.S. Congress, Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1986–1990*, pp. 41 and 63.

growth rate in 1990 are essentially the same. In view of these uncertainties, it would be unfortunate if fiscal policies were to reduce the deficit by reducing tax preferences for primary health and retirement protection. The social losses from employee benefit cutbacks could far outweigh any budgetary gains.

◆ Employee Benefits in the 1986 Budget

Federal spending for benefit-related programs is expected to total $355.8 billion in fiscal year 1986 (table 2).[1] This represents 37 percent of total 1986 outlays. Total "tax expenditures" related to benefits are estimated at $128 billion, or about 16 percent of projected federal revenues for fiscal year 1986. Four of the nine tax expenditures for individuals valued at more than $10 billion annually relate to benefits. Budget policy is, therefore, critical to employee benefits policy.

Retirement and Unemployment Programs

Total federal outlays for major income security programs are projected to increase by 6 percent from 1985 to 1986. Of the $13.3 billion projected increase in spending for these programs over the two-year period, $10.7 billion, or 80 percent, is comprised of increases in Social Security benefits (table 3). Outlays for the unemployment compensation program are expected to drop by $500 million between 1985 and 1986 due to improvements in the economy. In the 1985 budget, federal outlays for income security programs included Military Retirement System benefits for the first time. In the past, these benefits had been paid out of the national defense budget function.[2] This change, however, does not affect total federal outlays because it is an intra-budget transfer. Highlights of the administration's proposals in retirement and unemployment programs are outlined below.

Military Retirement System (MRS)—The administration proposes to eliminate the January 1986 cost-of-living adjustment (COLA) for military retirees' benefits, but outlays still increase $2.5 billion.

Table 2
Outlays for Major Groups of Benefit-Related Programs in the 1986 Budget (in billions)

Program Group	1984	1985	1986
Retirement and unemployment income programs[a]	$204.0	$215.2	$226.6
Health, safety and disability programs	111.6	126.1	129.3
Regulation and enforcement programs[b]	0.1	−0.1[c]	−0.1[c]
Total	315.7	341.2	355.8
Percentage of total outlays	37%	36%	37%

Source: *Budget of the United States Government, Fiscal Year 1986.*

[a] Totals reflect outlays under pre-1983 law. Before fiscal year 1985, benefits under the Military Retirement and Disability System were paid out of the national defense budget function rather than the income security function.
[b] Totals reflect the offset to outlays generated by the Pension Benefit Guaranty Corporation.
[c] Negative outlays reflect a net intake of revenue or decrease in spending by agency.

Table 3
The Administration's FY 1986 Budget Proposals for Major Retirement and Unemployment Programs (in billions)

Program	1984	1985	1986
Social Security (OASI)	$159.8	$171.2	$181.9
Civil Service Retirement and Disability Program	22.1	23.3	25.0
Proposed legislation	—	—	−0.7
Military Retirement and Disability System	16.5	15.8	18.3
Proposed legislation	—	0.1	−0.5
Railroad Retirement	3.7	3.9	4.1
Proposed legislation	—	—	b
Unemployment Compensation	18.4	16.8	16.3
Total	220.5	231.1	244.4
Total under pre-1983 law[c]	204.0	215.2	226.6

Source: *Budget of the United States Government, Fiscal Year 1986.*

[a] All figures are administration estimates of fiscal year program outlays.
[b] Less than $0.1 billion.
[c] Before fiscal year 1985, benefits under the Military Retirement and Disability program were paid out of the national defense budget function rather than the income security function.

[1] All spending figures are outlays, and all years are fiscal years unless otherwise noted.

[2] Budget functions are groups of federal programs or activities that address a common national need. There are eighteen budget functions, most with several subfunctions.

Civil Service Retirement System (CSRS)—The 1983 Social Security Amendments Act mandated coverage of new federal employees under the Social Security program and, by implication, required the formation of a new civil service retirement system. The 1986 budget assumes that a new CSRS will be in place by 1986. To meet this goal, the administration is planning to propose a new system that would contain a defined contribution plan. The employer contribution for Social Security payroll taxes plus employer contributions for the retirement system would total 20 percent of payroll on an actuarial normal cost basis.

The budget also proposes major changes in the current CSRS that would reduce outlays for the program by $731 million and increase receipts by $269 million. The changes would include the following:

- Normal retirement age. The retirement age for full benefits would be raised to age 65.
- COLAs. The January 1986 COLA would be eliminated. Future COLAs would be based on the lower of the increase in federal civilian pay or the Consumer Price Index (CPI). That portion of annuities exceeding $10,000 would receive only 55 percent of the scheduled COLA.
- Basis for benefits. The base for computing benefits would be changed from the highest three years to the highest five years of pay.
- Retirement credits. Retirement credits for unused sick leave would be phased out.
- Conformity with Social Security benefits. Survivor, adult student, and minimum benefits would be reduced to conform to those offered in the Social Security program.

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Railroad Retirement—The budget proposes certain changes in the railroad retirement system. The budget proposes to eliminate the January 1986 COLA, and apply a uniform COLA to the different benefit levels in the system. The rules for taxing Social Security benefits would apply only to the portion of railroad benefits that are equivalent to Social Security benefits.

Currently railroad employees are the only group of employees not covered by the general unemployment insurance program (UI). The railroad unemployment trust fund has to borrow from the railroad retirement fund when its obligations exceed its reserves. By the end of 1985, the railroad unemployment fund is projected to owe the railroad pension fund $1 billion. The budget proposes that rail employees becoming unemployed after September 1985 be covered under the regular UI fund. Legislation would be needed at the state level to cover these employees permanently.

Health, Safety, and Disability Benefits

The administration's proposed budget and legislative initiatives for selected health, safety, and disability programs are presented in table 4. Proposed outlays for 1986 of $99 billion for major health programs—Medicare, Medicaid, and health block grants—represent a 2.3-percent increase over 1985 estimated spending by these programs.

Medicare spending is projected to reach $75 billion in 1986. Principally because the administration anticipates freezing prospective reimbursement rates under the Hospital Insurance (HI) portion of Medicare, HI spending is projected to rise less than 1 percent in 1986 over the 1985 estimated level. Spending for physician services under the cost-reimbursing Supplementary Medical Insurance (SMI) portion of Medicare, however, is expected to rise much faster: 13 percent in 1986 over 1985 estimated SMI spending. Federal spending for state Medicaid programs that serve low-income elderly, disabled, and families with dependent children is projected to reach nearly $25 billion in 1986—a 7-percent increase over 1985 estimated spending.

Several administration proposals to reduce Medicare and Medicaid spending are reflected in the budget. These proposals might reduce 1986 outlays below projected outlays under current law. These proposals are summarized below.

Medicare—In September 1984, Medicare set the level of HI's prospective reimbursement rates for each of 467 diagnosis-related groups, effective through fiscal 1985. Based on available case-type and hospital cost data, the administration now estimates that the 1985 rates "excessively" compensate hospitals for the prospective cost of serving patients in each diagnosis-related group. As a consequence, the administration expects Medicare's Prospective Payment Commission, which reviews and sets Medicare reimbursement levels, to maintain, rather than increase, the 1985 prospective payment rates for hospitals in 1986. The administration also expects to freeze reimbursement limits for skilled nursing facilities, for psychiatric and other hospitals which are exempt from Medicare prospective reimbursement, and for home health agencies. Finally, the administration proposes to freeze reimbursements for direct expenses of medical education. Medicare reimburses hospitals for direct expenses of medical education separately from its prospective payments for hospital care based on diagnosis-related groups.

The administration proposes to reduce Medicare's payments, however, for indirect expenses of medical education. This proposal would reduce payments to teaching hospitals for research and educational activities not directly related to patient care. Other administration proposals affecting Medicare outlays include

Table 4
Administration's FY 1986 Budget Proposals for Selected Health, Safety and Disability Programs[a]

	Outlays (in billions)		
	1984	1985	1986
Medicare			
Hospital Insurance	$42.1	$48.8	$49.1
Proposed legislation			−1.2
Supplementary Medical Insurance	20.4	23.1	26.0
Proposed legislation		b	−0.7
Medicaid	20.1	23.0	24.6
Proposed legislation			−.9
Health block grants[c]	1.3	1.4	1.6
Proposed legislation	0.2[d]	0.2[d]	0.2
Social Security Disability Insurance	18.4	19.9	20.3
Special benefits for disabled coal miners	1.7	1.7	1.6
Proposed legislation			b
Occupational safety and health	0.4	0.4	0.4
Federal employee programs			
Federal employee health plan	1.3	1.1	1.5
Workers' compensation	0.2	0.2	0.3
Proposed legislation			b
Other health-related programs[e]	5.5	6.3	6.5
Total	111.6	126.1	129.3

Source: *The Budget of the United States Government, Fiscal Year 1986*, and unpublished data provided by the Office of Management and Budget.

[a] All figures are administration estimates of fiscal year program outlays.

[b] Less than $50 million.

[c] FY 1986 figure includes the budget authority estimate for the Primary Care block grant. All other components of the FY 1986 figure are outlays.

[d] Estimated federal outlays for the categorial programs which, under one proposal, would be merged into the Primary Care block grant.

[e] Includes federal outlays for health research (primarily for the National Institutes of Health), research and clinical training of health care providers, and consumer safety. Figures include estimated impact of administration proposals.

- establishing a nominal copayment for home health care exceeding twenty visits per year (HI now covers home health services without copayment)
- extending the existing freeze on Medicare SMI payments to physicians until October 1986
- freezing Medicare SMI payments for clinical laboratory tests, durable medical equipment, and other supplies
- increasing the proportion of SMI program costs financed by beneficiary premiums by 2 percentage points each year beginning in 1986, to reach 35 percent of program costs by 1990 (current law requires that beneficiaries pay premiums equal to 25 percent of SMI costs)
- indexing the SMI deductible, which was last adjusted in 1982, for changes in prices (the proposal does not specify which price index would be used)
- delaying Medicare eligibility to the first full month after age 65
- making employer health insurance plans first payer for services otherwise covered by Medicare for workers over age 69, at their election (this proposal extends current law applying to workers age 65 to 69)
- establishing a voluntary Medicare voucher that beneficiaries could use to purchase private insurance in place of direct Medicare coverage for health care expenses

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The administration now estimates that the 1985 [prospective reimbursement] rates "excessively" compensate hospitals for the prospective cost of serving patients in each diagnosis-related group.

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Medicaid—The administration proposes to maintain federal Medicaid spending approximately to the estimated 1985 level by: (1) increasing the states' flexibility to target services to optional eligibility groups (restricting the range of covered services to, for example, the medically indigent—persons who, except for health care expenses, would not meet the income standard for Medicaid), (2) allowing states to cover less costly services that might substitute for higher-cost care, and (3) encouraging states to improve their efforts to identify private insurers—for example, employer plans or automobile insurance policies—that by law have first responsibility for paying the health care expenses of persons eligible for Medicaid.

In addition to these changes, the administration proposes to divide federal participation in Medicaid into two parts: federal payment for state Medicaid administrative expenses and federal payment for Medicaid benefits. Federal payment for administrative expenses would be handled as a block grant; federal payment for Medicaid benefits would continue under the state-matching formula specified in law, but would be capped. Currently, the federal government matches all state Medicaid costs according to the statutory formula.

The administration's proposal would "close-end" federal Medicaid obligations, which means that state Medicaid spending above the federal cap would no longer be matched with federal funds. Critics of this proposal claim that close-ending federal obligations for Medicaid could result in the erosion of

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health care services provided by the program. The administration proposal would allow states to allocate excess administrative grant funds to support Medicaid benefits. In addition, the proposal would allow states to allocate up to 10 percent of their federal grant for Medicaid administration to other state-administered public assistance programs unrelated to health care.

The administration proposes to limit the growth of federal grants for Medicaid administration to increases in the implicit price deflator for the Gross National Product (GNP). The GNP price deflator differs from the Consumer Price Index (CPI)—a widely used measure of inflation in the prices of consumer goods and services—by including prices for capital goods and equipment as well. Between 1976 and 1982, the GNP price deflator rose more slowly than the CPI. The cap on federal spending for Medicaid benefits would be indexed by the medical care component of the CPI.

Federal Block Grants—The administration proposes to raise federal outlays for the four block grants to the states by 14 percent over the 1985 level. The federal block grant programs, administered by the states with minimal federal guidelines are: (1) Maternal and Child Health, (2) Preventive Health Services, (3) Alcohol, Drug Abuse and Mental Health, and (4) Primary Care. The administration has again proposed to move three additional federal programs—the Migrant Health program, the federal Black-Lung program, and federal spending for family planning—into the Primary Care block grant. As with the proposal to convert Medicaid to a grant program, moving these smaller categorical health programs into the Primary Care block grant would close-end federal spending obligations for them, and could result in the erosion of public support for those specific programs.

Social Security Disability Insurance (DI)—Federal spending for the DI program is projected to rise by 2 percent over 1985 estimated outlays. This increase is substantially less than the increase that would normally occur (4.3 percent by administration estimates) as a result of projected cost-of-living increases in DI benefits. The administration projects much slower net growth in DI spending as the Social Security Administration (SSA) reviews continuing eligibility for DI benefits. The Social Security Disability Reform Amendments Act of 1984 now requires that SSA demonstrate improvement in the medical condition of persons receiving DI benefits before SSA can terminate benefits based on an evaluation of recipients' ability to work. New rules defining medical improvement are due in April.

Federal Employee Health Benefits (FEHB) Program—The FEHB program is the largest multiple-option health insurance plan in the world. Federal outlays for FEHB in 1986 are projected to exceed 1985 spending by 36 percent. The administration proposes no change to FEHB that would affect 1986 spending projections. As a longer-term reform of FEHB, however, the administration proposes to

- base increases in federal government contributions on the GNP price deflator, rather than on the average premiums of the six largest plans in the program
- eliminate the 75-percent limit on federal contributions to the premium of employees who choose a low-cost health plan option, and rebate to employees the difference between the plan premium and the federal contribution
- increase the number of plan options available to federal employees.

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The administration projects that these proposed changes would actually raise federal outlays for FEHB in 1987, but begin to reduce FEHB costs in 1988.

Special Benefits for Disabled Coal Miners—This program provides monthly cash payments and medical benefits to miners who are disabled by black lung disease, and cash payments to their dependents and survivors. Some of these benefits are paid from the black lung disability trust fund, which is financed by a fee on coal production. The administration proposes to raise the coal fee to stabilize the trust fund deficit at about the level projected for year-end 1985: $2.9 billion.

Hospital and Medical Care for Veterans—The Veteran's Administration (VA) provides medical services, including hospital, outpatient, and nursing home care, to veterans by operating a nationwide medical care system. By administration estimates, the system is "expected to handle nearly 19 million outpatient visits and treat 1.4 million patients in VA and community facilities. This program is carried out in 172 hospitals, 229 outpatient clinics, 117 nursing homes and 16 domiciliary facilities."

The budget states:

> VA's primary health care mission is to treat veterans who were injured during military service for their service-connected disabilities. Currently, most of the system's users are either veterans with service-connected disabilities or low-to-moderate-income veterans. However, many users with no service-related disabilities have a higher income level and should be able to defray some or all of the costs of their medical care. This is especially true for younger veterans who are active in the workforce and participate in private health insurance plans, and for veterans over 65, most of whom are eligible for medicare. Therefore, the budget proposes a comprehensive reform of eligibility for VA medical care that would allow VA to sustain quality care for the most deserving veterans—primarily those with disabilities and those without resources to defray all or part of their health care expenses.

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The administration proposes to restrict the use of the system by all veterans—both under and over age sixty-five—whose income exceeds a threshold.

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The administration proposes two major reforms for veterans' hospital and medical care. First, the administration proposes to restrict the use of the system by all veterans—both under and over age sixty-five—whose income exceeds a threshold. Some Medicare experts believe that this "means test" would shift a substantial amount of the costs to Medicare.

Second, the administration is planning to propose legislation to require reimbursement from veteran-held private insurance plans for VA-sponsored care provided to nonelderly veterans without a service-connected disability. This means that private insurance would become the "primary payor," where it is now the "second payor." The budget argues that "allowing the government to recover costs would shift the burden of paying for VA care of these veterans from taxpayers to insurance companies and their policy holders with only minimal effects on premiums." Private insurers contend that the ultimate effect on premium levels could be significant since VA hospitals do not practice what have become standard cost containment practices in the private sector.

Table 5
Proposed Spending on Benefit-Related Regulation and Enforcement in the 1986 Budget (in millions)

Program	1984	1985	1986
Office of Pension and Welfare Benefit Programs	$28.5	$30.6	$28.3
Pension Benefit Guaranty Corporation	−9.9	−12.1	9.0
Proposed premium increase	—	−145.1	−183.5
Internal Revenue Service[a]	96.4	100.4	93.4
Proposed user fee	—	−40.4	−40.4
Other proposed legislation	—	−0.2	—
Total[b]	115.0	−66.8	−93.2
Total[c]	115.0	118.9	130.7

Source: *Budget of the United States Government, Fiscal Year 1986, Appendix.*

Note: Negative figures reflect a net intake of revenue or decrease in spending by agency.

[a] Totals include all IRS activities. Separate totals for benefit-related activities are not available.

[b] Includes proposed legislation.

[c] Does not include proposed legislation.

◆ Regulation and Enforcement Activities Under ERISA

The 1986 budget proposal provides estimates of total federal spending for the benefit-related regulation and enforcement activities of the three federal agencies charged with these duties under the Employee Retirement Income Security Act of 1974 (ERISA). Under current legislation, this spending would increase 14 percent from the actual 1984 level to $131 million in 1986 (table 5). The situation under proposed legislation would be dramatically different, with spending falling by more than 180 percent from the 1984 level to yield a net revenue intake of $93 million by these agencies in 1986.

The Office of Pension and Welfare Benefit Programs (OPWBP)

The OPWBP, an on-budget agency of the Department of Labor, collects and discloses pension plan information, investigates plans to enforce fiduciary standards, processes requests for exemptions from these standards, and issues advisory opinions to assist compliance. Under the proposed budget, spending for this agency's activities, which increased by $2.1 million between 1984 and 1985, would fall back slightly below the 1984 level to $28.3 million in 1986.

The Pension Benefit Guaranty Corporation (PBGC)

The PBGC, also an on-budget agency of the Labor Department, administers mandatory termination insurance programs to prevent the loss of pension benefits due to termination of covered private defined benefit plans. Agency activities, financed solely through the premiums paid by sponsors of private defined benefit plans, represent a net inflow of funds to the federal government when the program is viewed on a pay-as-you-go basis. Under the rules of federal budget accounting, therefore, a dollar in PBGC premium income has the same effect on the deficit as a dollar in income-tax revenue.

Under current law, the agency's activities are expected to result in federal outlays of $9.0 million in 1986. The budget contains a request to Congress to increase the premium that single employer plans must pay from the current level of $2.60 per participant to $7.50. Under such legislation, the administration estimates that the PBGC would take in net revenues of $175 million in 1986.

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The administration is proposing that the IRS impose a $100 user fee on letters of determination and private letter rulings.

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The Internal Revenue Service (IRS)

The IRS, an agency of the Treasury Department, includes among its responsibilities enforcing those provisions of the Internal Revenue Code that pertain to the tax status of qualified pension plans.

Under current law, the budget proposes 1986 funding for this agency at $93 million—$7 million lower than the 1985 estimate and $3 million lower than actual 1984 spending. The administration is proposing that the IRS impose a $100 user fee on letters of determination and private letter rulings, thus raising an estimated $40.4 million dollars each year. Under this and other proposed legislation, IRS funding would fall by 45 percent from the actual 1984 level to $53 million in 1986.

◆ Tax Expenditures

The Congressional Budget Act of 1974 required that each year's federal budget proposal be accompanied by a list of "tax expenditures." Tax expenditures are benefits perceived to flow to certain taxpayers as a result of the statutory treatment of certain sources or uses of income. These benefits are hard to measure and are a source of considerable controversy.

The administration's budget measures the effects of the tax structure on the budget and on the economy in two different ways. One method attempts to measure the federal revenue loss attributable to the tax-favored method treatment accorded certain sources or uses of income. This is the tax expenditure concept that has traditionally been used in the budget process.

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Tax expenditure estimates do not take into account the secondary effects of enacting or repealing a tax-code provision. If repealing a tax expenditure makes the affected activity more costly, taxpayers might be encouraged to undertake other tax-favored activities.

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A second procedure, the outlay equivalent approach, is also used by the Reagan administration to calculate tax expenditure estimates. This method, in use since the 1982 budget, estimates a tax provision's cost as the amount of direct outlays that would be required to provide the same after-tax benefit as that conveyed by the tax provision. In general, therefore, outlay equivalents are higher than revenue loss estimates, reflecting the fact that a comparable outlay program would result in taxable income to the beneficiary. Outlay equivalents allow the tax system's effects on economic decision-making to be measured in a way comparable to the outlay side of the budget, but they do not have the same direct interpretation as revenue loss estimates. Unless the marginal tax rate being imputed to the beneficiary of the tax provision is known, the outlay equivalent measure cannot provide even a rough estimate of the federal revenue that could be gained if specific provisions were eliminated from the tax code. This *Issue Brief*, therefore, focuses on revenue loss measures because of their clearer interpretation.

The budget document cautions the reader against using either measure as a projection of the increased federal revenue that would accompany repeal of particular provisions. Four problems make such an interpretation impossible:

- Repeal of some provisions could affect aggregate income and growth levels. Changes in incomes, in turn, would yield lower projections of revenue.
- Tax expenditure estimates do not take into account the secondary effects of enacting or repealing a tax-code provision. If repealing a tax expenditure makes the affected activity more costly, taxpayers might be encouraged to undertake other tax-favored activities.
- Tax expenditures are estimated on a cash-flow basis without allowing for the lag involved in phasing a particular tax provision in or out of the tax code. Revenues actually

realized during such a transition would, therefore, be lower than the published estimates.

- The procedure for estimating tax expenditures does not take into account interactions among tax-code provisions. For example, restricting the tax deductibility of employer-provided health insurance could increase the usefulness of the itemized deductions for medical care. Alternatively, employers might increase the generosity of other benefits to make up for reduced health benefits. In either case, restricting the health-insurance deduction would not produce as much added revenue as the published estimates suggest.

These cautions aside, however, the federal budget crisis is likely to keep tax expenditures at the forefront of budget policy debates. Employee benefits, in turn, will play a major role in tax expenditure discussions. The administration's budget proposal for fiscal year 1986 lists 106 such tax expenditure provisions. Sixteen of them are judged to benefit corporations only; 39 benefit both corporations and individuals; and 51 solely benefit individuals. Of this latter group, 20 provisions, or nearly 40 percent, affect private- and public-sector employee benefits. One corporate benefit—the investment credit for employee stock ownership plans—relates to employee benefits.

Table 6
Revenue Loss Estimates for Employee Benefit Tax Expenditures in the 1986 Budget by Function, Fiscal Years 1984–1986[a]
(in millions)

Provision	1984	1985	1986
Commerce and Housing Credit:			
Exclusion of interest on life insurance savings	$3,190	$3,915	$3,655
Education, Training, Employment, and Social Services:			
Employer educational assistance	15	110	25
Exclusion of employer provided child care	5	10	20
Exclusion of employee meals and lodging (other than military)	725	795	870
Exclusion of contributions to pre-paid legal services plans	30	40	15
Investment credit for ESOPs	1,430	1,910	2,330
Health:			
Exclusion of employer contributions for medical insurance premiums and medical care	19,145	21,245	23,700

Table 6—cont'd

Provision	1984	1985	1986
Social Security and Medicare:			
Exclusion of Social Security benefits:			
OASI benefits for retired workers	13,815	12,830	13,385
Benefits for dependents and survivors	3,755	3,780	3,990
Disability insurance benefits	1,245	1,165	1,185
Income Security:			
Exclusion of railroad retirement system benefits	615	450	455
Exclusion of workmen's compensation benefits	2,165	2,325	2,500
Exclusion of special benefits for disabled coal miners	155	150	150
Exclusion of untaxed unemployment insurance benefits	2,045	1,605	1,260
Exclusion of disability pay	75	b	b
Net exclusion of pension contributions and earnings:			
Employer plans	44,050	44,205	55,110
Individual Retirement Accounts	10,990	12,050	13,410
Keogh plans	1,410	1,585	1,685
Exclusion of other employee benefits:			
Premiums on group term life insurance	1,910	2,055	2,220
Premiums on accident and disability insurance	125	125	130
Income of trusts to finance supplementary unemployment benefits	20	20	30
Veterans benefits and services:			
Exclusion of veterans disability compensation	1,640	1,675	1,720
Exclusion of veterans pensions	195	190	190
Total	108,750	112,235	128,035

Source: Derived from *Special Analyses, Budget of the United States Government, Fiscal Year 1986*, table G-2.

[a] Budget functions are groups of federal programs or activities that address a common national need. There are eighteen budget functions.

[b] No revenue loss attributable.

Three provisions account for 72 percent of the total $128.0 billion in benefit-related tax expenditures projected for fiscal year 1986 (table 6). One provision excludes a portion of Social Security retirement benefits from adjusted gross income. Another provision defers taxes on contributions to and earnings on employer-sponsored pension plans. The final provision excludes employer contributions for health insurance and health care from adjusted gross income. Employer pensions alone account for 43 percent of 1986 benefit-related tax expenditures.

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The budget reflects cutbacks in tax preferences for employee benefits enacted last year. The Educational Assistance Act, which expired in 1983, was recently extended by Congress through December 31, 1985. Under the new law (P.L. 98-611), Congress placed a limit of $5,000 on employer-provided educational assistance and extended the benefit retroactively for the year 1984, with no penalties for employers who did not withhold taxes from employees' salaries in that year. The revenue loss estimate for employer education assistance drops to $25 million in fiscal year 1986 from $110 million in 1985, reflecting the projected expiration of this provision.

Under the Deficit Reduction Act of 1984, the payroll-based employee stock ownership plan (PAYSOP) permits an investment tax credit equal to 0.5 percent of aggregate employee compensation paid to all participants in the plan in return for the employer's stock contribution to the plan. Prior to the 1984 act, the value of this credit was scheduled to rise to 0.75 percent in 1985, 1986, and 1987.

At the end of 1983, the exclusion from taxable income of employee payments received during periods of injury or sickness was replaced with an expanded tax credit for the elderly and permanently disabled. The exclusion of disability pay from taxable income, therefore, does not give rise to tax expenditure after fiscal year 1984.

While the latest revenue loss estimates for most benefit-related tax-code provisions remained fairly stable in relation to last year's estimates, tax expenditures for employer-sponsored pensions did drop significantly. Last year's budget projected $56.3 billion in pension-related tax expenditures for fiscal year 1985, but this total fell to $44.2 billion in this year's budget (table 6). This drop can be explained by two features of the calculation yielding this figure. First, pension plan contribution growth has slowed recently in response to good investment returns (on accrued assets of prior contributions) and uncertainty about the future of pension fund regulation. Second, the Treasury now computes tax expenditures on fund earnings differently than in prior years. In the past, tax expenditures on fund earnings were computed at the marginal tax rate applied to working participants. The calculation now assumes that part of fund earnings are attributable to retirees, whose marginal tax rates are lower. Since retirees pay taxes at lower marginal rates than employed persons, the use of the current tax computation decreases the tax expenditure.

◆ Administration Tax Proposals

The budget contains only one tax proposal that would affect the tax treatment of employee benefits and related expenditures. This proposal restructures the dependent care tax credit. This credit is available to persons who require child care to work or attend school. While all taxpayers can benefit from this credit to some degree under current law, the budget proposes to increase the value of the tax credit for taxpayers with adjusted gross incomes of $10,000 or less, and reduce it on a sliding scale for persons with incomes above that level, until it is eliminated for those with adjusted gross incomes of $60,000 or more. The revenue cost of this proposal is expected to be $25 million in 1987. This proposal was also made in the fiscal year 1985 budget.

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◆ The Budget and Tax Reform: The Larger Picture

The administration's budget proposal is generally an important vehicle of federal employee benefits policy; it is not the only vehicle, however. This year's budget proposal contains relatively few initiatives in the employee benefits area.

The employee benefits initiatives that are likely to come before the Congress this year are contained in the Treasury Department's tax reform proposal, which was submitted to the president in November 1984. President Reagan has endorsed tax reform as one of his second-term goals. The administration has taken an important step toward achieving this goal by beginning discussions with the authors of two major congressional tax reform proposals, Sen. Bill Bradley (D-NJ), Rep. Richard Gephardt (D-MO), Rep. Jack Kemp (R-NY), and Sen. Robert Kasten (R-WI). These discussions are aimed at blending the major features of the Treasury proposal and the congressional proposals.

Observers and participants in the legislative process agree that major tax reform will take a back seat to the 1986 budget and deficit reduction on the legislative agenda. The president's efforts, however, to make tax reform a higher-profile issue are very significant and should not be disregarded. In addition, the revenue-raising items in the Treasury's proposal could look very attractive to congressional committees, apart from tax reform, when Congress begins to concentrate on the deficit. Tax reform, therefore, will not be brushed aside this year, but rather it will likely be used—in one form or another—to aid in the task of deficit reduction.

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