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Flexible benefit plans provide significant incentives for health care cost containment.

EBRI Survey on Flexible Benefit Plans

Flexible benefit plans have emerged as an employer response to the needs of a diverse work force and to the need to contain health care costs. They have become controversial partly because they are relatively new, and data on them have been unavailable. This *Issue Brief* is a SPECIAL REPORT on the results of the EBRI 1984 Survey of Flexible Benefit Plans. The survey was undertaken to obtain detail on the types of plans offered, the benefits included in them, and the choices made by employees. The survey obtained data on 82 plans sponsored by 70 employers and covering over 400,000 employees.

The two most important public policy issues related to flexible benefit plans concern their impact on health insurance spending and their potential federal revenue costs. The flexible benefit plans surveyed provide significant incentives for health care cost containment, and participants respond to these incentives. Participants in flexible benefit plans, which allow choice among benefit options, select plans with stronger cost-sharing features than traditional plans covering health insurance participants nationwide. Federally financed research studies have shown that these features reduce demand for health services.

The survey results suggest that some of the fears about the adverse tax policy consequences of flexible benefit plans have been exaggerated. Flexible spending accounts (FSAs) financed by employee salary reduction are considered by many to offer significant potential for federal income tax base erosion, yet they attract much lower participation rates than flexible benefit plans as a whole. Employees who elect to reduce their salaries in these programs contribute an average of $542, or about 12 percent of the average allowable maximum contribution in those accounts that use salary reduction. Benefits such as group legal services and dependent care, which depart from the traditional menu of risk protection and income security benefits, are not offered as widely or selected as frequently as the more traditional benefits. Although FSAs can cost federal revenues, their modest utilization levels along with their effects on health care spending actually limit potential federal revenue losses that could result from widespread use of these plans. Flexible benefit plans, therefore, appear to offer a choice-based solution to a difficult public policy problem.

Introduction

This report uses new survey data to explore current policy issues in the regulation of cafeteria or flexible benefit plans. Flexible compensation[1] is a popular concept in employee benefit design today. Its popularity stems in large part from its ability to accommodate the employee benefit needs of an increasingly diverse work force at a constant or decreased total cost to the employer.

This *Issue Brief* discusses two kinds of flexible benefit arrangements. One is described here as a "broad-based flexible benefit plan," in which employees can choose which benefits and how much of each benefit to receive. Such a plan contains at least two benefits. The other arrangement, which can either be part of a broad-based flexible benefit plan or stand alone, is called a "flexible spending account," in which employees designate pretax wages and salaries, employer contributions, or both to buy certain benefits or pay insurance premiums.

This survey is based on 82 benefit plans sponsored by 70 companies. The plans range in size from 33 to 84,000 employees (table 1).[2] Major results of the survey are presented, and their implications for federal policy toward flexible benefit plans are discussed in the following sections:

- types of flexible benefit plans identified in the survey,
- firms using the plans and the employees participating,
- benefits included in the plans,
- effects of the plans on health care spending, and
- survey implications for policy debates concerning flexible benefit plans.

Legislative History of Flexible Benefit Plans

Cafeteria plans in some form have existed for more than a decade, yet their legislative status has undergone considerable modification.[3] Prior to the passage of the Employee Retirement Income Security Act of 1974 (ERISA), flexible benefit plans existed on the basis of private letter rulings issued by the Internal Revenue Service (IRS). Explicit statutory authority for such plans did not exist. The letter rulings merely certified that the plan did not result in taxable income for the employees. Income is taxable if a recipient can use such benefit payments without restrictions. Without explicit statutory authority for flexible benefit plans, the fact that employees could choose their benefits could mean that the employee had received taxable income. The passage of ERISA complicated the design of such plans, although plans that did not contain taxable benefits could still be qualified.

Under the Revenue Act of 1978, flexible benefit plans were explicitly authorized in section 125 of the Internal Revenue Code. A qualified plan could offer choice among two or more benefits, including nontaxable benefits, taxable benefits, or cash. The Deficit Reduction Act of 1984 (DEFRA) further modified the statutes to exclude taxable benefits from the menu of benefits that could be offered.

Table 1
Size Distribution of Plans

	Number of Plans	Average Number of Employees Eligible	Employees in Smallest Plan	Employees in Largest Plan
Flexible Benefit Plans	20	5,277	33	35,000
Flexible Spending Accounts				
Flexible spending accounts[a]	32	9,728[b]	405	84,000
Premium-payment plans	30	6,964	405	60,000

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.
[a] Free-standing accounts only.
[b] For free-standing flexible spending accounts, the survey only collected information on the number of persons eligible to contribute to a salary-reduction account. Since many accounts do not use salary reduction, the number of persons eligible to participate in flexible spending accounts is higher than this total.

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[1] For more information on flexible compensation plans, see *Fundamentals of Employee Benefit Programs*, 2nd ed. (Washington, DC: EBRI, 1985), pp. 217-223.

[2] A technical appendix describing the survey, the data, and the tabulations is available from EBRI.

[3] This summary is based on "Cafeteria Approaches to Benefit Planning" by Robert W. Cooper and Burton T. Beam, Jr. in Jerry S. Rosenbloom, *The Handbook of Employee Benefits: Design, Funding, and Administration* (Homewood, Ill.: Dow-Jones-Irwin, 1984), pp. 373-375.

Table 2
Financing Methods Used in FSAs

Financing Method	Free-Standing FSAs		FSAs in Flexible Benefit Plans	
	Number	Percent	Number	Percent
Credits from other benefits	0	0	8	42
Flat-rate employer contribution	16	50	8	42
Salary-graded employer contribution	3	9	3	16
Seniority-based employer contribution	1	3	2	11
Salary reduction	17	53	17	89
Other formula	3	9	0	0

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.

The structure of flexible spending accounts (FSAs) has been a particular policy concern in recent years. When Treasury regulations sanctioned the use of salary reduction to finance section 401(k) deferred compensation programs, many employers began to use salary reduction for flexible benefit programs as well. The 1984 law requires that sums allocated to an FSA using salary reduction have to be elected in advance and that unused sums have to be forfeited at the end of the year.

DEFRA also mandated that the Department of Health and Human Services (HHS), in consultation with the Treasury Department, report to Congress on the effect of these plans on health care cost containment and on their public policy effects in general. The EBRI survey was undertaken in conjunction with this effort and in consultation with HHS and Treasury staff. The survey was designed to measure the effects of these plans on health care costs and to determine which benefits are offered by employers and used by employees. This information, in turn, allows measurement of the federal revenue effects of this plan.

◆ Types of Flexible Benefit Plans

There are many different types of flexible benefit plans, since the concept can be tailored to address a variety of employer needs. This survey was designed to obtain information about the following two major types:

- those that allow employee choice among benefits as well as choice of the amount of each benefit to receive; and
- those that create individual accounts that can be used only to reimburse certain expenses for specific employees.

The survey was not designed to include plans allowing only after-tax choice among different health insurance options, since such plans are not section 125 flexible benefit plans.

Flexible Benefit Plans

Twenty plans in the survey are broad-based flexible benefit plans. Eighteen include a flexible spending account. According to industry sources, about 125 plans of this type were in operation at the time the survey was conducted. This survey, therefore, captured about 16 percent of existing plans. This group should not be considered a statistically representative sample. It is best to assume that the findings of this survey apply only to the plans represented in it.

Flexible Spending Accounts

The remaining 62 plans in the survey are free-standing flexible spending accounts. The survey asked for information on two major types of FSAs: general purpose accounts and premium-payment accounts.

Thirty-two accounts are general purpose accounts that can be used to purchase a wide variety of benefits. In general purpose FSAs, either employee contributions (through salary reduction), employer contributions, or both can be used to buy benefits not offered in the employer's regular menu or to supplement those that are offered. The remaining 30 accounts can be used only to pay the employee's share of insurance premiums on a pretax basis.

General Purpose FSAs —These accounts can either be part of a broad-based flexible benefit plan or free-standing accounts. Eighteen plans, or 90 percent of the broad-based flexible benefit plans in the survey, contain FSAs. This proportion has grown in recent years. In 1982, the firm of Peat, Marwick, Mitchell & Co. found that only 39 percent of flexible benefit plans in place or being considered included an FSA.[4] In addition to the FSAs contained in flexible benefit plans, the EBRI survey also identified 32 free-standing general purpose FSAs that are not part of a broad-based flexible benefit plan.

FSAs use a variety of financing methods in different combinations. FSAs commonly use employer contributions,

[4] Peat, Marwick, Mitchell & Co., *The Future of Flexible Compensation* (New York: Peat, Marwick, Mitchell & Co., 1984) p. 2.

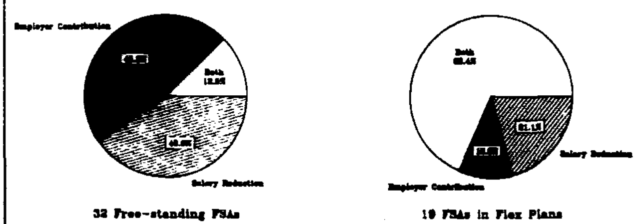
but FSAs in flexible benefit plans are much more likely to allow salary reduction. One-half of all free-standing FSAs and close to one-half of FSAs in flexible benefit plans use flat-rate employer contributions to finance all or part of the account. Nearly all FSAs in flexible benefit plans and just over half of free-standing FSAs allow employees to make contributions using salary reduction (table 2).

Employer contributions are sometimes derived from savings the employer is accumulating elsewhere in the benefit package. One source of such savings is the replacement of a richer health insurance plan with one carrying increased deductibles, copayments, or both. To the extent that the employer contribution is financed through such savings, it changes the form, but not the total amount, of employer spending for benefits. Maximum employer contributions to FSAs tend to be smaller than maximum employee contributions. The maximum employer contribution to an FSA in the EBRI survey averaged $718. Similarly, those FSAs that were financed through credits generated by other benefit elections reported a maximum employer contribution of $700. In contrast, the average maximum on salary reduction in plans allowing employee contributions was $4,594.

Over 40 percent of FSAs contained in flexible benefit plans can be financed through credits generated by the employee's other benefit elections (table 2). That is, the employee may choose the lower level of life or health insurance the employer offers, thereby generating credits that can be converted into cash to finance the FSA. Free-standing accounts, in contrast, are unrelated to other benefits provided, and therefore do not use such credits.

Many FSAs use more than one financing method. Salary reduction is the single most popular method for financing FSAs, either alone or in combination with an employer contribution. Over one-half of the free-standing FSAs in the survey reported using salary reduction, as did almost 90 percent of the FSAs in flexible benefit plans (chart 1). Of

Chart 1
FSA Financing by Type of FSA



Source: EBRI 1984 Survey of Flexible Benefit Plans.

the free-standing FSAs using salary reduction, the majority used it as the only financing method. In contrast, among the FSAs contained in flexible benefit plans, only 21.1 percent using salary reduction used it as the only financing method and 68.4 percent used it in combination with an employer contribution.

The small sizes of both FSA groups surveyed make generalizations from these data hazardous, but the differences in financing methods could reflect differences in plan design and in the types of incentives plan sponsors want to build into their plans. The higher incidence of employer contributions in flexible benefit plan FSAs (15 out of 19—or 79 percent—compared with 19 out of 32—or 59 percent—of free-standing accounts) could reflect the desire of employers to encourage participation in broader-based choice plans. In contrast, sponsors of free-standing accounts may be less likely to contribute to the FSA because they have unilaterally made changes in the benefit package, eliminating the need for offering employees incentives to participate.

Table 3
Flexible Benefit Plans by Industry

	Flexible Benefit Plans		Free-Standing FSAs		Premium-Payment Plans	
	Number	Percent	Number	Percent	Number	Percent
Industry						
Bank/financial	4	20	5	16	9	30
Hospital	2	10	2	6	3	10
Manufacturing	12	60	17	53	14	47
Service/schools	2	10	6	19	3	10
Other	0	0	2	6	1	3
Total	20	100	32	100	30	100

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.

Premium-Payment Accounts —The survey identified 30 FSAs that only allow the participant to pay insurance premiums with pretax dollars. Medical, disability, and life insurance premiums are commonly paid through these plans. Many general purpose accounts can also be used to pay insurance premiums.

◆ Which Industries Have Flexible Benefit Plans?

The EBRI survey identified flexible benefit plans in a broad range of industries. Manufacturing or other industrial firms sponsored 60 percent of the broad-based plans, 53 percent of the free-standing FSAs, and 47 percent of the premium payment accounts (table 3). Banks and other financial organizations were the next largest group represented, with 20 percent of the broad-based plans, 16 percent of the free-standing FSAs, and 30 percent of the premium-payment accounts. Hospitals and other service or educational concerns each accounted for a small share of the plans identified.

The heavy representation of capital-intensive industries in the survey suggests that flexible benefit plans are attractive to all employers, regardless of their capital-labor mix. The fact that flexible benefits are found in all sectors suggests that the decision to implement a flexible benefit plan is influenced by such factors as the absolute size of the work force, competitive pressures, and employee relations factors. In a firm with a large work force, even a small reduction in compensation costs could affect profits, and competitive pressures could lead a firm to update its benefit package even if the resulting cost savings were not very important.

The survey identified relatively few collectively-bargained plans. Only 4 of the 52 plans that were asked responded that they were collectively bargained (table 4). Benefit consultants believe that flexible benefit plans tend not to be collectively bargained, because in union settings the union, not the employee, decides the benefit package. Since these agreements are generally stated as a decision to pay a certain amount per hour for benefits, a benefit structure in which each employee could have a different benefit package would be difficult to bargain and communicate.

Table 4
Collectively Bargained Plans

Type of Plan	Total Plans	Collectively Bargained Plans	Percent of Total
Flexible benefit plan	20	2	10.0
Free-standing FSA	32	2	6.3

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.

◆ Who Participates in Flexible Benefit Plans?

Eligibility and participation are distributed quite differently across plans. Eligibility tends to be broadly distributed within sponsoring firms. Employees' decisions to participate, in contrast, vary with plan features and requirements.

Eligibility

In general, flexible benefit plans include all permanent, full-time employees. Flexible benefit plans tend to have somewhat stricter eligibility standards than free-standing FSAs. This could be due to the fact that most employers impose some age and service criteria for participating in the major benefits, whereas contributing to a free-standing account need not imply that the employee is eligible to participate in all the benefits the employer offers. Temporary employees are excluded from 95 percent of flexible benefit plans but only 75 percent of free-standing FSAs (table 5). Part-time employees are also excluded from 60 percent of flexible benefit plans and 47 percent of free-standing FSAs. About one-quarter of the plans exclude employees on a paid leave of absence. A small number of plans also exclude employees depending on

Table 5
Eligibility Standards by Type of Plan and Type of Employee

	Flexible Benefit Plans		Free-Standing FSAs	
Excluded Groups	Number	Percent	Number	Percent
All part-time employees	12	60	15	47
Employees on paid leave of absence	4	22	8	25
Temporary employees	19	95	24	75
Clerical	0	0	1	3
Production	0	0	5	16
Technical	0	0	2	6

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.

Table 6
Eligibility and Participation Rates by Type of Plan

Type of Plan	Number of Plans	Persons Covered	Persons Participating	Percent Participating
Flexible benefit plans	20	105,544	102,407	97
Premium-payment plan	30	208,923	198,583	95
FSAs using salary reduction[a]				
Free-standing FSAs	13	131,030	79,105	60
FSAs in flexible benefit plans	16	98,423	60,513	61

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.
[a] The number of plans in this category refers only to those reporting eligibility and participation data. Seventeen plans in each category reported that they allow salary reduction.

their occupational status. This probably means the sponsor has different plans covering different groups of employees.

Participation

Participation rates depend on the type of plan offered. Flexible benefit plans generated the highest participation rates in the survey at 97 percent of eligible employees (table 6). Premium-payment accounts also reported high participation rates at 95 percent. Participation is mandatory in over two-thirds of these plans, however. Consequently, a high participation rate would be expected.

The lowest participation rates occur in FSAs financed by salary reduction. (Participation rates were not collected for free-standing FSAs that do not use salary reduction.) In free-standing FSAs, 60 percent of employees eligible to contribute elect to do so. In FSAs financed through salary reduction that are part of flexible benefit plans, 61 percent elect to contribute. The difference in participation rates among plans could mean that not all employees find salary reduction useful. Salary reduction plans could also require some employee education, leading to increased participation in later years. Most of the plans in the survey were implemented in 1982 or later, giving them at most two years of experience at the time of the survey.

Although both participation rates and salary reduction levels could rise in the future as these plans become better understood, they could also fall. At the time the survey was conducted, many plans could still offer employees the chance to cash out unused balances at the end of the plan year. Such balances would result in taxable income. The option to cash out unused balances means the employee is not penalized for guessing wrong about expenses. Nearly two-thirds of the FSAs identified in the survey offered this option. After July 1, 1985, however, employees will lose unused balances at the end of the year. Consultants report that the increased risk

Table 7
Salary Reduction Elections in Flexible Spending Accounts by Income Groups, 1984[a]

Earnings	Employees Contributing	Average Employee Election	Percent Distribution: Employees	Percent Distribution: Elections	Elections as a Percent of Earnings[b]
Less than $15,000	4,125	$366	18.6	12.5	2.9
$15,000–$19,999	4,049	413	18.2	13.9	2.4
$20,000–$29,999	5,260	496	23.7	21.7	2.0
$30,000–$39,999	3,885	545	17.5	17.6	1.6
$40,000–$49,999	2,176	648	9.8	12.4	1.5
$50,000 or more	2,738	969	12.3	22.0	1.5
All employees	22,233	$542	100.0	100.0	2.1

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.
[a] Employee totals in this table are lower than those reported in table 8 because these totals only include those plans providing detail on the income distribution of participants. The table contains data for ten firms and eleven FSAs, with a total of 56,728 employees eligible to contribute.
[b] Percents computed at midpoint of earnings range except in the lowest and highest earnings groups. In the lowest group, the percent was computed at $12,500 and in the highest group it was computed at $65,000.

this places on the employee is already making employees more conservative in their elections and, therefore, further reducing potential federal revenue losses.

Ten firms in the survey reported enough data on 11 FSAs to allow detailed examination of participation levels by income groups. For these plans, the participation rate was 39.2 percent of those eligible. A large share of the participants were moderate earners, many of whom might not expect to receive heavy tax benefits from salary reduction. Of those employees choosing to participate, 60.5 percent earned less than $30,000 and 36.8 percent earned less than $20,000 (table 7). Those earning less than $30,000 made up the majority of participants, yet they accounted for less than half of total salary reduction elections. Those earning less than $30,000 accounted for 48.1 percent of total salary reduction elections, and those earning less than $20,000 accounted for 26.4 percent.

Although salary reductions increased significantly with earnings, they were a larger share of total earnings at lower income levels. The average election was close to twice as large a share of earnings at lower as at higher earnings levels. In the lowest income group, elections averaged 2.9 percent of earnings, falling to 1.5 percent among those earning $40,000 or more. The average participant's salary reduction election was 2.1 percent of earnings.

The relatively low participation levels in salary reduction plans, the moderate levels of elections compared with allowable levels, and the failure of salary reduction elections to increase in proportion with income suggest that there are limits to how much employees are willing to reduce disposable incomes to reduce tax liability and purchase added benefits. The high salary reduction ceilings in most FSAs apparently do not encourage employees to convert large amounts of ordinary consumption expenditures into tax-favored spending. In particular, dependent care financed out of FSAs would require high salary reductions. If dependent care were priced at the federal minimum hourly wage, for example, care for a 40-hour week could easily exceed $7,000 per year for one dependent. Since the income tax credit for dependent care is worth less at higher than at lower income levels, one might expect to find higher average salary reduction elections as income increases. Instead, even in the highest income group, average salary reduction elections of $969 are just 21 percent of the average allowable maximum of $4,594 in the plans surveyed. This is well under the amount that care for one dependent could cost.

Which Benefits Are Offered?

The survey asked for information on benefits offered in broad-based flexible benefit plans and in various FSAs. In all types of plans, the benefits most often offered are health insurance premiums and coverage of uninsured health, dental, and vision care expenses. Even in plans offering a wide variety of benefits, the highest participation rates are observed in the health, dental, and vision care portions of the plans.

Flexible Benefit Plans

Of the 20 broad-based flexible benefit plans identified in the survey, 17 included a health insurance plan and 16 included a health expense FSA (table 8). The next most commonly offered benefits were life insurance (15 plans), disability in-

Table 8
Participation Rates in Various Benefits in Flexible Benefit Plans

Benefit	Plans Offering Each Benefit	Participation as Percent of Eligible Employees[a]
Health plan	17	93
single	17	30
family	17	63
Life insurance		
basic	15	64
supplemental	14	60
dependents	14	49
other	6	47
Accident and sickness or short-term disability	11	71
Long-term disability	14	38
Capital accumulation		
401(k)	14	53
thrift	1	99
profit sharing or stock bonus	1	99
other capital accumulation	2	80
Stock option plan	3	22
Flexible spending account		
health care account	16	60
dependent care	13	4
legal services	4	8
other	2	b
Vacation, personal leave or other paid time off	11	49
Group legal services	1	b
Salary reduction benefits other than above	4	57

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.
[a] Not all plans reporting that they offer tax benefits reported participation. Percentages are based on those plans that reported participation.
[b] This plan failed to report participation.

Table 9
Benefits Available in FSAs

	Number of FSAs Including Benefits	Percent of FSAs Including Benefits[a]
Health Insurance Premiums		
Medical	26	67
Dental	15	38
Vision	5	13
Life Insurance Premiums		
Basic	2	5
Supplemental	2	5
Dependents	2	5
Accident and Sickness or Short-Term Disability	2	5
Long-Term Disability	3	8
Uninsured Health Expenses		
Medical	34	87
Dental	32	82
Vision	31	79
Dependent Care	22	55
Legal Services	8	21
Capital Accumulation	5	13
Other Benefits	6	15

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.

[a] Calculated as a percent of those reporting. In the majority of cases, 39 out of 51 plans reported whether the indicated benefits were offered.

surance (11 offering short-term and 14 offering long-term), 401(k) plans (14 plans), and dependent care FSAs (13 plans). Group legal services were offered in 4 plans through the FSA and in one plan as part of the flexible benefit choices.

Employee participation rates in the various benefits vary widely. The highest participation rates were observed in health plans (93 percent of those eligible), short-term disability insurance (71 percent), health care FSAs (60 percent), and basic life insurance (64 percent). High participation rates were also reported in several capital accumulation plans, but only the participation data for section 401(k) plans are based on a large enough number of plans to allow generalizations to be made. These plans attracted 53 percent of the employees eligible to participate in the flexible benefit plan. The lowest participation rates were observed in the dependent care and legal services FSAs (4 and 8 percent, respectively). These elections suggest that the traditional risk protection and income security benefits are the most important benefits to employees.

Flexible Spending Accounts

General Purpose FSAs—Some of the same benefit patterns were observed in FSAs as in flexible benefit plans. Over two-thirds of the FSAs reporting detail on benefits offered the participant the chance to pay health insurance premiums out of the account (table 9). Nearly 90 percent allowed the participant to use the account for uninsured health expenses, and 82 and 79 percent, respectively, allowed the account to be used for uninsured dental and vision care expenses. Dependent care was included in 55 percent of the accounts.

FSAs are not heavily used for insurance premiums other than medical insurance. Dental insurance premiums were included in 38 percent of the accounts, and other types of insurance premiums were included in 5 to 13 percent of the accounts, depending on the type of premium. As in the flexible benefit plans, legal services were offered in a minority of general purpose FSAs, with only 21 percent of plans with benefit detail reporting that legal services were offered.

Premium-Payment Accounts —As in the other types of plans, medical expenses were the dominant feature of premium-payment accounts. The most commonly offered benefit in these plans is medical insurance, with all plans that reported data allowing the employee to pay these premiums through the plan (table 10). Over two-thirds of the plans also allow the employee to pay dental insurance premiums. Employee contributions for group life insurance and accidental death and dismemberment insurance were allowed in just under half of the plans. These results suggest that employee contributions occur to some degree in a broad range of insurance plans.

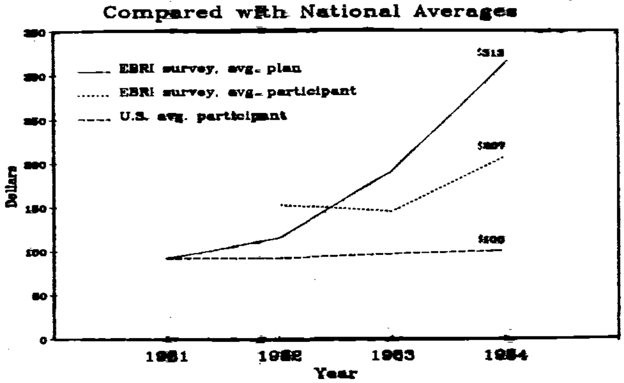
Table 10
Benefits Offered in Pretax Premium-Payment Plans

Benefits	Number of Plans	Percent Offering Each Benefit[a]
Medical (including HMO)	30	100
Dental	18	69
Group life	11	46
Disability	7	30
Medicare	4	17
Accidental death & dismemberment	10	43
Other	4	15

Source: Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.

[a] Percents are calculated on the basis of the plans reporting whether the benefits were available. Not all plans reported the data.

Chart 2
Deductibles in Health Insurance Plans Surveyed Compared with National Averages



Source: EBRI 1984 Survey of Flexible Benefit Plans, and U.S. Bureau of Labor Statistics.

Summary

Critics of flexible compensation plans argue that they allow employees to use pretax dollars for predictable expenses, such as dependent care, that would have been paid in any event. Evidence from the EBRI 1984 Survey of Flexible Benefit Plans does not support this view. Although the plans offer a wide range of benefits, the most widely offered benefits remain the major risk protection and income security benefits that employers have traditionally offered. These benefits also attract the highest participation rates among employees. Of the less-traditional benefits, only dependent care is offered by a significant number of employers in the survey. Even there, however, participation rates among eligible employees do not approach the rates observed for the traditional risk protection and income security benefits.

◆ Can Choice Reduce Health Care Spending?

The two most important public policy issues related to flexible benefit plans concern their impact on health insurance spending and their potential federal revenue costs. The results of this survey suggest that flexible benefit plans provide significant incentives for health care cost containment.

The design of health insurance plans and flexible benefit plans can affect health care spending in two ways. First, cost-sharing features, such as deductibles and copayment requirements, can reduce utilization of health services. Second, these plans can change the share of total health care spending that is tax-preferred.

Cost-Sharing Features of Health Insurance Plans

Cost-sharing features, such as deductibles and copayment requirements, impose a cost on the patient for using health care services. Patients appear to respond to the institution of such requirements by reducing their utilization of health care services.[5] Lower utilization rates, in turn, can bring down insurance premiums through their favorable effects on group experience ratings. In addition, lower demand could contribute to bidding down per-unit prices of health-related goods and services. If this happened, direct federal spending for health programs like Medicare (part B) could also be reduced.

Health insurance plans in the broad-based flexible benefit plans surveyed have significantly higher levels of cost sharing than do plans in the nation as a whole. In 1984, the average health insurance participant in medium and large firms nationwide paid a deductible of $100 (chart 2). In contrast, the health insurance participant in the present survey paid an average deductible of $207. The plans surveyed had even stronger cost containment incentives, with an average deductible of $313. These results suggest that flexible benefit plans are channeling participants into plans with strong incentives for economizing on health care spending.

The Tax-Preferred Share of Total Spending

Some have feared that the tax-preferred share of health care spending could increase in the presence of innovations like FSAs and the financing of ancillary health benefits, such as vision care and dental insurance, through flexible benefit plans. FSAs and ancillary health benefits could allow employees to receive from their employer or to purchase on a pretax basis health care services that would otherwise have been financed with after-tax dollars. At the same time, however, such innovations are often introduced along with incentives to employees to economize on the high-cost hospital-related components of health care spending. In the presence of such incentives, both total health care spending and its tax-preferred component could decline.

The responses to this survey suggest that such a tradeoff may be occurring. The majority of FSAs, for example, allow participants to pay for uninsured vision care and dental expenses, and many allow participants to pay vision care and dental insurance premiums. Federal tax revenues do decrease, therefore, if these expenditures would otherwise have been made with after-tax dollars.

At the same time, however, participants in flexible benefit plans face higher deductibles in their basic health plans, which means that they pay more out-of-pocket costs associated with their basic health plan than do employees who do not participate in flexible benefit plans. Even the opportunity to pay these costs through an FSA imposes higher costs on the participant than if the entire cost were paid through an

[5] This effect was documented in a study conducted for the Department of Health and Human Services by the Rand Corporation, Charles E. Phelps, *Health Care Costs: The Consequences of Increased Cost Sharing* (Santa Monica, Calif.: Rand Corp., 1982), p.9.

employer-financed health plan. Therefore, flexible benefit plans may be increasing the tax-preferred share of ancillary health spending, but they probably reduce basic health care spending through the higher deductibles they impose. Since basic health care is the larger and higher cost component of health care spending, flexible benefit plans may be reducing total tax-preferred health care spending.

◆ Implications of Flexible Benefit Plans for Federal Revenues

The potential effects of flexible benefit plans on federal revenues have generated concerns among policymakers. At various times, Treasury officials have projected the revenue costs of these plans at $10.2 billion to $17 billion over the period from 1984 to 1989.[6] The Congressional Budget Office has estimated that these plans could cost the Treasury $8.5 billion over the period 1986 to 1990.[7]

The revenue effects of flexible benefit plans depend on the type of plan being considered. In theory, a broad-based flexible benefit plan offering choice among a wide range of benefits should not increase federal revenue losses, and could reduce them. Such a plan offers the employer a way to repackage the benefits already available while keeping total benefit costs constant or growing at a slower rate than they might otherwise grow. A broad-based plan containing an employer-financed FSA should have similar effects on federal revenues, since such an FSA is often financed by the employer's savings elsewhere in the benefit package.

Federal revenue losses could result from FSAs financed through salary reduction. Even in these plans, however, the federal revenue effects are ambiguous. An FSA that allows the employee only to make up for cutbacks in employer-provided benefits with pretax dollars would generally not have any federal revenue effects if employee dollars substitute exactly for employer dollars.

Concerns over the federal revenue costs of FSAs have arisen primarily as a result of the high limits in many accounts financed by salary reduction. The results of this survey suggest that these concerns may be overstated for two reasons. First, eligible employees are not responding to the incentives to reduce taxable income as enthusiastically as some critics of FSAs fear. Employee participation in salary reduction plans has been lower than in other types of flexible benefit plans. Salary reduction elections among those participating averaged about 12 percent of the average allowable maximum, according to the EBRI survey. Second, the debates over the federal revenue effects of FSAs have tended to ignore the health care cost containment effects of the cost-sharing features generally introduced into health insurance plans along with the introduction of an FSA.

Policy discussions over the federal revenue effects of flexible benefit plans in general and FSAs in particular have tended to ignore the fact that these plans are aimed primarily at containing employer expenditures for health care. FSAs are frequently introduced either in conjunction with the institution of a health insurance plan with cost-sharing features or as an incentive to employees to select a plan with cost-sharing features from a varied menu of plans offered by an employer.

The federal revenue savings from such cost-sharing effects should be considered an offset to federal revenue losses resulting from employee contributions to FSAs. The value of these offsets could be significant. If FSA participants behaved as those identified in the current survey, total salary reduction elections could range from $0.4 billion to $18.8 billion per year, depending on the proportion of employees eligible and the proportion choosing to participate (table 11). Based on the results of the EBRI survey, revenue losses resulting from these salary reduction elections could range from $0.1 billion, if 2 percent of the work force is eligible to participate in these plans, to $4.1 billion, if every employee is eligible.

Considering the offset reduces these totals. If all participants paid the same deductibles as those in flexible benefit plans, health care spending could fall by 10 percent.[8] As a conservative estimate, suppose that health insurance premiums paid by employers likewise fell by 10 percent. This would lead to a 10 percent drop in federal revenue losses attributable to employer payments for health insurance (these revenue losses for 1984 were estimated at $19.1 billion in the administration's fiscal year 1986 budget proposal). Taking this offset into account would reduce present federal revenue losses by about 25 percent. Federal revenue losses based on the EBRI survey results would range from $0.1 billion to $3.2 billion per year

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[6] Statement of John B. Chapoton, assistant secretary of tax policy, Department of the Treasury, before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, July 26, 1984; and statement of Ronald A. Pearlman, acting assistant secretary of tax policy, Department of the Treasury, before the Subcommittee on Social Security and the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, September 17, 1984.

[7] Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*. A Report to the Senate and House Committees on the Budget-Part II (Washington, DC: U.S. Government Printing Office, 1985), p. 288.

[8] This estimate is based on the responsiveness of participants to deductibles found in the Rand study. Since the estimate in that study was based on 1978 data, the deductible in that study was inflated to 1985 price levels to arrive at this estimate.

Table 11
Federal Revenue Effects of Salary Reduction FSAs Under Alternative Assumptions, 1984[a]

Eligible Employees[b]		Total Salary Reduction Elections (in billions of dollars)	Revenue Losses (in billions of dollars)[c]	
Number (in millions)	Percent of work force		Without health cost offset	With health cost offset
2.1	2	0.4	0.1	0.1
10.5	10	1.9	0.4	0.3
26.3	25	4.7	1.0	0.8
52.5	50	9.4	2.1	1.6
78.8	75	14.1	3.1	2.4
105.0	100	18.8	4.1	3.2

Source: Calculations based on data from Employee Benefit Research Institute 1984 Survey of Flexible Benefit Plans.
[a] Calculations assume $1.790 trillion in wages and salaries in 1984.
[b] Calculations assume average salary reduction elections of 2.1 percent of income and 50 percent participation rates among eligible employees.
[c] Revenue losses are calculated assuming a marginal tax rate of 22 percent for the average participant. This is the tax rate paid by a married taxpayer earning the average wage of salary reduction participants with one dependent and utilizing the standard deduction.

(table 11). Only if every employee in the U.S. is eligible to participate in an FSA and only if the average contribution rate remains the rate observed in the survey, would the revenue losses approach the administration and congressional estimates. The offset could be up to twice as large if all flexible benefit participants elect the higher cost-sharing health insurance plans included in flexible benefit plans.[9]

◆ Conclusions

Flexible benefit plans have emerged as an employer response to the needs of a diverse work force and to the need to contain health care costs. Flexible benefit plans have now become controversial partly because they are relatively new, and data on them have been unavailable.

The results of the EBRI 1984 Survey of Flexible Benefit Plans suggest that some of the fears about the adverse public policy consequences of flexible benefit plans have been exaggerated and that some of the public policy advantages of these plans have been understated. Salary reduction elections by participants are modest compared with allowable limits, suggesting that disposable income for other uses is more important to participants than tax advantages for benefits they may not need. Benefits such as group legal services and dependent care, which depart from the traditional menu of risk protection and income security benefits, are not offered as widely or selected as frequently as the more traditional benefits. Although FSAs can cost federal revenues, these factors act to contain potential federal revenue losses that could result from widespread use of these plans.

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Perhaps most importantly, flexible benefit plans offer participants incentives to reduce health care spending, and participants respond to these incentives. Flexible benefit plans, therefore, appear to offer a choice-based solution to a difficult public policy problem.

[9] Increases in coinsurance rates were also found to reduce health care spending in the Rand study. Average coinsurance rates found in the EBRI survey were very close to nationwide levels, leading to no added cost containment effects from this feature.

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