COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES

HEARING ON

ADMINISTRATION AND OTHER PROPOSALS
CONCERNING TAX SHELTERS, ACCOUNTING ABUSES,
AND CORPORATE AND SECURITIES REFORMS

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Statement of

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* The authors are research associates of the Employee Benefit Research Institute. The views expressed in this statement are those of the authors and do not necessarily reflect the views of the Employee Benefit Research Institute, its trustees, members or other staff.
EMPLOYEE BENEFITS: EQUITY, TRENDS AND FEDERAL REVENUE IMPLICATIONS

Statement of

D. Chollet, Ph.D.,
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E.S. Andrews, Ph.D.*

The growth of employee benefits as a tax-favored form of compensation has dominated the debate over federal tax policy for several years. Many who are concerned about the federal deficit, and many observers of Social Security's financial problems, see the growth of tax-favored employee benefits as an erosion of the tax base and 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 -- alarms those who see the growth of employee benefits only as erosion of the tax base. This appraisal of employee benefits is naive. The growth and redefinition of tax-favored employee benefits must be evaluated in a broader, more sophisticated context to design efficient long-run public policy.

Tax expenditures for employee benefits must be considered in terms of the social benefits that result. The emergence of new forms of employee benefits represents employer efforts to reduce benefits costs and, subsequently, total compensation costs. The growth of some new types of benefits may represent a net addition to the payroll tax base, if they supplant the growth of more traditional benefits.

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The Growth of Employee Benefits

Employee benefits can be considered in three groups:

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

In 1983, tax-favored employee benefits (excluding federal, state and local government contributions to public employee pensions) represented just under 30 percent of all employee benefits and 8 percent of total compensation. Since 1950, tax-favored employee benefits as a share of compensation have grown at an average annual rate of 4.5 percent, compared to somewhat slower growth in legally required benefits and taxable benefits (see table 1).

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. Since 1950, 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 in excess of total compensation at an average annual rate of 7 percent.
<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Total Benefits</td>
<td>2.5</td>
<td>2.3</td>
<td>1.9</td>
</tr>
<tr>
<td>Legally Required Benefits</td>
<td>3.2</td>
<td>3.3</td>
<td>1.5</td>
</tr>
<tr>
<td>Fully Taxable Benefits</td>
<td>1.4</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Tax-Favored Benefits, Total</td>
<td>4.5</td>
<td>4.2</td>
<td>4.1</td>
</tr>
<tr>
<td>Private Pension and Profit-Sharing</td>
<td>3.7</td>
<td>4.5</td>
<td>5.7</td>
</tr>
<tr>
<td>Group Health</td>
<td>6.3</td>
<td>5.1</td>
<td>7.0</td>
</tr>
<tr>
<td>Group Life</td>
<td>2.1</td>
<td>-1.7</td>
<td>---</td>
</tr>
<tr>
<td>Other</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
</tbody>
</table>


*b Excludes the Federal Civilian Retirement System, Railroad Retirement System, state and local retirement systems and military pensions. Since these systems are not governed by the same funding standards that determine private employer pension contributions, the growth rates of private and public employer contributions are incomparable.*
Tax Preferences and Federal Revenue Loss

Private retirement program tax expenditures form the single largest category of tax expenditures in the federal budget. They arise from the deferral of taxes paid on pension and retirement saving contributions, and earnings on these contributions. The tax deferral of pension and retirement saving contributions represent current revenue deferral; taxes are paid on withdrawals from the funds after the worker retires. In a lifetime context, however, gross federal revenue loss (excluding public entitlement expenditures that would result from lower levels of private retirement income) are significantly lower than measures of current revenue deferral suggest. As much as 75 percent of the real value of taxes deferred during pension participants' working careers is ultimately paid in retirement.¹

Employer contributions to group health insurance are also a large source of federal tax expenditures, fourth in the list of all tax expenditures by size. The exemption of employer health insurance contributions from Social Security, corporation income and individual income taxation is an important source of current federal revenue loss.

Tax expenditure estimates are a poor guide for setting either federal tax policy or federal retirement or health policy.² Nevertheless, the high


tax expenditure estimates for pension and group health insurance plans continue to draw the public's attention and appraisal of these plans' tax-favored status. Measurement of current or lifetime tax loss, however, is only part of the task of evaluating tax preferences for employer pension contributions, retirement saving, and employer-sponsored health insurance. The benefits that derive from tax preferences for these plans must also be appraised.

Federal tax preferences for pensions, retirement saving, and health insurance have encouraged high rates of participation in these plans among workers and their families at all income levels. Widespread coverage under these plans promises to enhance federal tax revenues in future years, and minimize current and future reliance on public entitlement programs.

**Coverage Growth in Tax-Favored Employee Benefits**

Tax laws favoring employer retirement and health insurance plans were enacted under the premise that wide coverage of workers and their dependents under these plans is desirable social policy. In fact, 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.3 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.4

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4 S. Korczyk, _Ibid._
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 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 82 percent were covered by an employer plan. Recent Congressional concern over health insurance loss among unemployed workers and their families suggests that the Congress continues to perceive high rates of private health insurance coverage as a public policy goal.

Widespread health insurance and pension coverage contribute importantly to the income security of current workers and their families, and to the income security of future retirees. Tax preferences for employer health insurance contributions, employer pension contributions and individual retirement saving are a critical factor in determining 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.

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. 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 security for workers with fragmented employment histories, and reduce the public cost of health care entitlement programs.

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 25-34) is nearly twice that of workers who are retiring today (see table 2).

Table 2

<table>
<thead>
<tr>
<th>Cohort Age in 1979</th>
<th>All Families</th>
<th>Married Couples</th>
<th>Single Persons</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Percentage to Receive Benefit</td>
<td>Average Amount of Benefit</td>
<td>Percentage to Receive Benefit</td>
</tr>
<tr>
<td>25-34</td>
<td>71</td>
<td>$12,417</td>
<td>75</td>
</tr>
<tr>
<td>35-44</td>
<td>65</td>
<td>11,190</td>
<td>67</td>
</tr>
<tr>
<td>45-54</td>
<td>52</td>
<td>8,656</td>
<td>58</td>
</tr>
<tr>
<td>55-64</td>
<td>37</td>
<td>5,315</td>
<td>44</td>
</tr>
</tbody>
</table>


Note: Real dollars are calculated using 1982 as the base year.
Equity: The Income Distribution of Major Benefits

In part as a result of tax incentives, participation in employer pension and health insurance plans is high. In 1979, 48 percent of the total workforce participated in an employer pension plan; 74 percent were covered by an employer group health insurance plan. Among full-time full year workers, rates of coverage are very high. 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. 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).

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 insurance plans are low or middle-income workers. In 1979, 75.3 percent of all workers who were 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 3). The distribution of employer health coverage by family income (reflecting the prevalence of multiple-earner households and dependents coverage) shows a similar

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7 S.J. Schieber and P.M. George, Ibid., pp 38 and 54; and D. Chollet, Ibid. Pension coverage rates for full-time full-year workers include only nonagricultural workers, age 25-64, with one year of service and working more than half-time. Health insurance coverage rates include all full-time nonagricultural workers who worked 50 weeks or more during 1979.

Table 3

DISTRIBUTION OF EMPLOYEES WITH PENSION AND HEALTH COVERAGE
BY EARNINGS, 1979

<table>
<thead>
<tr>
<th>Earnings</th>
<th>Employees with Pension Coverage</th>
<th>Employees with Health Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total (in millions)</td>
<td>Percent</td>
</tr>
<tr>
<td>Less than $20,000</td>
<td>27.8</td>
<td>75.3</td>
</tr>
<tr>
<td>$20,000 to $49,999</td>
<td>8.7</td>
<td>23.7</td>
</tr>
<tr>
<td>$50,000 and over</td>
<td>0.3</td>
<td>0.9</td>
</tr>
<tr>
<td>Totala</td>
<td>36.9</td>
<td>100.0</td>
</tr>
</tbody>
</table>


a Detail may not add to totals because of rounding.
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 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 4).

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 less than $30,000. In short, there is no evidence that tax preferences for employee benefits or private retirement savings plans favor only highly paid workers.

**Trends in 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. The growth of new benefits--in particular, Section 401(k) plans and cafeteria plans--however, generally represents an effort by employers to contain the cost of employee benefits.

The growth of employer pension costs has 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

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9 EBRI tabulations of Internal Revenue Service data for tax year 1982.
Table 4

RATES OF EMPLOYER GROUP HEALTH INSURANCE COVERAGE
AND EMPLOYER CONTRIBUTIONS TO COVERAGE AMONG NONELDERLY PERSONS
BY FAMILY INCOME, 1979 (in percent)

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


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.
own. A Section 401(k) plan allows employers to contain their retirement plan costs by encouraging employee retirement savings. 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 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, 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, are 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 savings 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. (Cafeteria plans may include a reimbursement account or flexible spending account; they are not synonymous with, or dependent on, flexible spending accounts.)

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 inflating 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--for generous health insurance coverage. Like Section 401(k) plans, cafeteria plans enable employers to meet the benefits demands of an increasingly diverse workforce--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, providing significant tax advantages to participants that are not available to workers without cafeteria plans, have recently come to the attention of this Committee. Where the Congress believes abuses exist, limits or guidelines for the use of benefits within cafeteria plans should be set. However, examples of possible abuses within cafeteria plans do not mitigate the overall efficiency of these plans and their cost advantages for both employers and employees.
Federal Revenue Implications

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 been made lightly and with 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 Section 401(k) plans do, in fact, substitute for the growth of more traditional pension benefits, they represent an addition to the current payroll tax base. This seems to be a favorable development for those concerned about near-term budget deficits.

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 unambiguously represent erosion of the tax base.
Summary and Concluding Remarks

Tax laws favoring specific employer retirement and health insurance plans were enacted under the premise that wide coverage of workers and their dependents under these plans is desirable social policy. The growth of worker coverage by pension 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 all workers, most workers who participate 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 past 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 public goal. Private pensions, 401(k) plans and IRAs appear to serve that segment of the population who will be least adequately served by Social Security -- middle-income workers and their families, as well as higher-income workers. Conversely, these persons continue to be the most important source of funding for the Social Security system and the public sector at large.
The emergence of nontraditional benefits warrants more careful scrutiny than it has been given. These benefits generally serve the interests of employers, who are seeking to contain benefits costs, and employees, who demand a more diversified package of benefits than ever before. Nontraditional benefits may serve best those workers whose needs are least adequately met by more traditional benefits -- young workers and employed parents. Further, the growth of nontraditional benefits may actually contribute to the payroll and income tax bases, to the extent that they supplant traditional, tax-exempt or fully tax-deferred benefits. These implications of emerging nontraditional benefits merit further attention.