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of

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*The views expressed in this statement are solely those of Dallas Salisbury and should not be attributed to the Employee Benefit Research Institute, its officers, trustees, sponsors or other staff.

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Introduction

Every major tax reform proposal offered to date has significant implications for the tax treatment of employer-provided employee benefits. Each, therefore, would affect the economic security of millions of active and retired workers.

Although the proposals seek to provide the same overall level of tax revenue as currently exists, each plan treats employee benefits very differently. A comparison of the various provisions and bills is outlined in Attachment 1 (EBRI Issue Brief number 38, January 1985).

The differences among the bills indicate that some members of Congress believe there are ways to reform the tax code, and maintain the current aggregate revenue levels, without necessarily taxing all or most employee benefits. For example, the provisions of the Kemp-Kasten tax proposal attempt to accomplish this.

The revenue loss or tax expenditure estimates usually identified with the repeal of employee benefit tax provisions must be viewed with great caution. Attachment 2, "Evaluating Pension-Related Tax Expenditures," written by EBRI research associate Sophie M. Korczyk, briefly discusses why these estimates should not be the sole basis for any reform of the tax system as it affects employer-provided benefits.

The social and economic value of core employee benefit programs such as health, life and disability insurance and pensions is of paramount importance to a majority of taxpayers. Voluntary employer-provided benefit programs and mandatory social programs work together effectively. If changes in the tax treatment of employee benefits such as health and retirement were to reduce the benefits received by a significant number of workers and retirees, the federal government could ultimately find itself having to make up the difference through increased social program expenditures.

In determining tax reform priorities, the characteristics of each employee benefit and why it exists must be analyzed carefully. The purpose of this statement is to analyze the reasons for the current employee benefit tax incentives, discuss their effectiveness, and explain why even though the public supports tax reform in general, public opinion surveys register strong opposition to the taxation of employee benefits.

The Role Of Employee Benefits In Society

Concern for the economic security of workers and their dependents motivated the government to encourage the development of employee benefit programs--public and private, voluntary and mandatory.

Recent surveys indicate that employee benefit programs continue to be provided by employers out of concern for the economic security of employees, a desire for good employee relations, the need to retire workers, and the competitive pressure from other employers. For employees, economic security and tax effectiveness are primary concerns: Tax is not paid until an economic benefit is actually received.

Mandatory and voluntary tax-favored benefits cost about 5 percent of wages and salaries in 1950. By 1984 this had grown to just over 16 percent, with 40 percent being mandatory, 30 percent being voluntary tax-exempt, and 30 percent being voluntary tax-deferred. As these costs have grown, plan sponsors--the government, private corporations, and others--have shifted from a gratification emphasis of "What benefits should we have?" to a planning emphasis of "How much are we willing to spend and how should we spend it?" Employee benefits have become something to be managed and carefully scrutinized.

In recent years, employers have expended great effort to contain the cost of providing benefits to their employees. This has meant changes in plan designs, new types of plans, new cost-sharing arrangements, and, in extreme cases, total elimination of protection. The great expansion of flexible compensation has been driven forward by this urge to contain and reallocate costs.

The government has been a part of that effort--both in its own right as an employer and in its role as legislator and regulator.

Employee benefit programs are frequently lumped together with working condition "fringe benefits"--parking, merchandise discounts, business lunches, etc.--and termed fringe benefits as well. While this might have been appropriate in the 1930s, it is not appropriate today.

Employee benefits, as distinguished from fringe benefits, have certain characteristics that are implicit in this structure:

(1) They provide for the basic social and physical well-being and financial security of working men and women and their families;

(2) They have the potential to provide widespread benefits on a nondiscriminatory basis to large numbers of persons at all economic levels;

(3) They are sufficiently important that government programs have been enacted to provide protection to some groups and that these programs would have to be extended to additional groups in the absence of private sector programs; and

(4) It is more cost-effective to provide them for most groups through tax-preferred private sector programs than through direct governmental expenditures.

The Role Of Employee Benefits In Providing Economic Security

In addition to the initial purposes of employee benefit programs, there are some other principles that can be used to guide future assessments by the public and private sectors.

ONE: The government taxes many of the benefits at the time they are actually paid to the individual. This approach assures that individuals have the financial resources to pay the taxes on their benefits when they are levied, rather than taxing them on a hypothetical value of benefits they have not received.

TWO: The national commitment to economic security has been very successful. It should be maintained in a form that allows persons at all earnings levels to participate. Employers, for example, now provide protection to more than 162 million persons through voluntary programs. According to the Social Security Administration, more than 50 percent of new retiree households have employer pension income, and the number grows each year as the system matures. Health insurance, according to the Congressional Joint Tax Committee, provides health protection worth $100 billion for a "tax subsidy" of less than $30 billion. Direct provision of health benefits by the government would require $100 billion in new taxes. Other employee benefits--parts of the economic security commitment--provide similar cost/benefit returns to the federal government.

THREE: The U.S. economic security system is successful because of the public and private partnership, the employer and individual worker partnership. The system is flexible, accommodating changes in industry structure, family structure, labor force, and age demographics. The system is working, with the role of employers and individuals growing at a net savings to the taxpayers. The economic security system should only be changed if it is essential, and then only after careful evaluation of all the long-term costs of change in terms of economic security, federal spending, and intergenerational tensions.

FOUR: Evaluation of economic security tax preferences should include an assessment of:

(1) How the benefit enhances economic security;

(2) The degree to which the benefit reduces claims on direct government expenditures in areas where the nation has a commitment to economic security;

(3) The degree to which the program benefits persons (workers) at all levels of an employer's payroll on a nondiscriminatory basis;

(4) The number of persons whose economic security is enhanced as a result of receiving the employee benefit; and

(5) Relative cost and administrative burdens of change versus revenue gains of treating a benefit differently than under current law.

Public Support For Employee Benefits

Public support for employee benefits and the implicit national economic security policy they represent is strong.[1] Surveys taken in late 1984 by Roper asked chief executive officers (CEOs) and individuals to express agreement or disagreement with four statements. The first two were commonly used arguments for modifying the tax-favored status of employee benefits.

			CEOs	Individuals
First:	Employee benefits should be taxed to add to the general revenues of the federal government, thus reducing federal budget deficits.	Agree	20	19
		Disagree	77	75
		Don't Know	3	6

			CEOs	Individuals
Second:	Employee benefits should be taxed to force employees to more carefully use their benefits.	Agree	25	20
		Disagree	72	72
		Don't Know	3	8

These responses indicate that executives and those who work for them believe that deficits and cost containment are not sufficient reasons to change the tax treatment of employee benefits, and that these incentives for economic security should be maintained.

Responses to the next two statements indicate why they favor the present system of employee benefit economic security programs.

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[1] Employer Attitudes Toward Employee Benefits and Tax Change, a Mercer-Meidinger survey, September 1984, of 502 CEOs; a Roper survey of 150 CEOs, November 1984; a Roper survey of 500 individuals, December 1984; a Pen & Schoen Associates survey of 1,000 voters, January 1985.

			CEOs	Individuals
First:	Employee benefits should retain their tax-favored status to provide employees with additional economic security and to contribute to their well being.	Agree	81	85
		Disagree	17	11
		Don't Know	2	4

			CEOs	Individuals
Second:	Employee benefits should retain their tax favored status to encourage employers to provide certain benefits for their employees that otherwise would come from public monies.	Agree	78	81
		Disagree	21	13

The public believes that employee benefits help their economic security in areas where they would otherwise demand government programs and therefore have to pay for them with higher tax payments. The complementary nature of Social Security and employer-sponsored retirement programs and Medicare, Medicaid, and employer-provided health insurance support this sentiment.

The public also, however, supports tax reform, and have certain attitudes regarding specific approaches that would affect employee benefits. CEOs favor a modified flat tax to the current system by a margin of 58 percent to 31 percent, while individuals favor it by 44 percent to 37 percent.

Yet, support for tax reform may fall apart when individuals focus on the details. For example, Roper found that 58 percent of CEOs oppose a health tax cap; Pen & Schoen found that 77 percent of voters oppose it. This aspect of public opinion regarding tax reform and employee benefits may not yet have been closely focused upon by advocates of reform.

A recent survey conducted by Hamilton & Staff for the ERISA Industry Committee and the Association of Private Pension and Welfare Plans indicates American workers oppose taxing employee benefits--whether to reduce the deficit, lower marginal tax rates or make the tax code simpler. While 56 percent of workers said they think the current tax system is unfair and 71 percent want it simplified, 56 percent said they oppose taxing employee benefits to reduce marginal rates, 61 percent oppose taxing benefits to make the system fairer and 60 percent oppose taxing benefits to reduce the deficit.

Effectiveness Of Existing Tax Incentives

The tax incentives now in the law have made a difference to economic security, as indicated by economic statistics and taxpayer attitudes. And, as might be expected, the most widespread employee benefit programs are those that have been encouraged by the tax code for the longest period of time. These programs:

- provide protection against the loss of income or unexpected expenses in the event of illness;
- loss of income in the event of retirement or disability, and
- the loss of support by dependents in the event of death.

Data from the Bureau of Labor Statistics on the extent of coverage under these programs among those employed by firms with more than 250 employees indicate the programs are very widespread. The same is true for the population as a whole, with more than 162 million individuals benefiting economically from employer-provided benefits. Ninety-eight percent of the individuals surveyed by Roper had health insurance; 71 percent of firms and 63 percent of individuals had pensions; 99 percent of firms and 73 percent of individuals had life insurance; and 85 percent of firms and 61 percent of individuals had disability insurance. Forty-one percent of firms had thrift savings plans; 33 percent of firms had 401(k) plans; and 16 percent had reimbursement accounts.

The surveys indicate that these employee benefits are important to employees and employers alike. Ninety-three percent rate health insurance as very important; 84 percent rate pension plans as very important; 72 percent rate life and disability protection as very important. Significantly, 61 percent said that it would be very difficult to afford the purchase of health insurance if it were not provided by the employer.

Implications Of Tax Proposals

The Treasury's and other fundamental tax reform proposals would make significant changes in the tax treatment of employee benefits. Surveys indicate that tax reform would affect employer decisions. The November 1984 Treasury reform proposal would, for example, eliminate Section 125, the section of the Internal Revenue Code that allows for plans giving employees a choice among benefits with salary reduction. That proposal, and others, would tax at least a portion of health insurance premiums.

While both Roper and Mercer-Meidinger found that about 60 percent of CEOs opposed the health tax cap, more than 40 percent said their response to a tax cap would be to offer a "choice" among plans. This compares to 16 percent now doing so. Twenty-two percent would simply reduce the health insurance offered were a cap imposed. As a result, consultants argue that a tax cap would cause "choice" plans to become the rule rather than the exception. They argue that under these proposals employers would be compelled by their employees to offer a choice on group life and other benefits made fully taxable and a health option below the tax cap amount.

The tax reform plans would also begin to respond to a new trend that is troubling to many in the federal government--increased use of lump-sum distributions paid before retirement to individuals who change jobs. Lump-sum distributions would be discouraged--by imposing excise taxes, eliminating ten-year forward averaging, etc. This is not a defined benefit versus defined contribution issue: It is a question of the method of payout. The implicit Treasury Department question is this: Will there be a check in the mail box along with the Social Security check when the individual retires?

Finally, there would be a result that can't yet be quantified--loss of economic security through loss of employee benefits.

Economic Implications

A number of studies have been done to assess horizontal and vertical equity of the tax provisions. The Treasury Department conducted such a study in 1982, the results of which were confirmed by a study recently completed by EBRI economist Sophie Korczyk. Table 1 shows that the tax value of employee benefit incentives parallels tax payments, with low income persons getting more of the value of the tax reductions than their share of tax payments and the highest paid getting less. In other words, a change in the tax treatment of benefits would have a regressive result. More recent studies by EBRI economists Korczyk and Deborah Chollet confirmed these findings, as did a CBO analysis of the health care tax cap proposal published in 1983.

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: (1) pension and retirement saving contributions and (2) earnings on these contributions. The dollar value of the tax expenditure demands that equity and efficiency questions be explored. A major

Table 1

Revenue Loss for Major Benefits and Taxes Paid by Income Class as Percent of Total Adjusted Gross Income Class, 1981[a]

Adjusted Gross Income Class	Exclusion of Employer Contributions for Medical Insurance & Medical Care	Exclusion of Worker's Compensation Benefits	Exclusion of Untaxed Unemployment Insurance Benefits	Exclusion of Disability Pay	Net Exclusion of Pension Contributions & Earnings[b]	Exclusion of Insurance Premiums[c]	Percent of Total Taxes Paid
Less than $10,000	6.5%	29.4%	50.6%	83.0%	4.0%	4.5%	2.6%
$ 10,000 to $ 15,000	8.7	16.6	26.4	14.4	5.6	6.1	5.7
$ 15,000 to $ 20,000	10.7	11.7	9.7	0.7	7.8	8.8	8.0
$ 20,000 to $ 30,000	28.3	24.8	12.8	2.0	22.6	24.0	20.6
$ 30,000 to $ 50,000	32.8	12.9	0.4	–	34.1	34.7	30.4
$ 50,000 to $100,000	10.6	3.5	–	–	17.8	15.2	18.1
$100,000 to $200,000	1.9	0.7	–	–	6.0	4.8	8.3
$200,000 and over	0.4	0.3	–	–	2.1	1.9	6.3

SOURCE: EBRI calculations based on U.S. Congress, Congressional Budget Office, <u>Revising the Individual Income Tax</u>, July 1983 (Washington, D.C.: U.S. Government Printing Office, 1983), Table 9, pp. 62 and 63.

NOTE: Percents may not add to 100.0 percent due to rounding.

[a] 1981 income levels and 1982 law.

[b] Includes the exclusion of contributions and earnings for employer plans and plans for the self employed and others.

[c] Includes premiums for group-term life insurance and accident and disability insurance.

new study by Korczyk assesses these incentives in a lifetime context. She finds that the economic value to the government is significantly greater than tax expenditure numbers alone would imply. As much as 72 percent of the real (i.e., inflation-adjusted) value of taxes deferred during the pension participants' working career is ultimately repaid as income tax during retirement.

Table 2 shows that Treasury tax expenditure statistics, calculated on a cash-flow basis, leave the impression that a very large proportion of current tax deferrals is permanently lost to the Treasury. Treasury statistics imply that 83 cents out of every deferred dollar is permanently lost, with the other 17 cents accounted for by current tax payments made by retirees. When examined in a lifetime context, the proportion of deferred taxes lost to the Treasury ranges from 14 cents out of every dollar to 40 cents, depending on whether or not one adjusts for inflation and interest on deferred taxes and the interest factor used.

One factor that has not generally been considered in discussing changes in the tax treatment of employee benefits, however, that could involve a significant shift in the incidence of the income tax is the increasing cost--and, therefore, value--of benefits as workers age. This would represent a major effect of tax policy change.

Employee benefits such as defined-benefit pensions and health insurance are almost always discussed as a flat-dollar cost per employee or as a level percentage of pay per employee. Employee representatives, employees, and employers have been content with this approach since the actual distribution of cost does not affect either the taxes to be paid by the employee or the

Table 2

How Much of Pension-Related Tax Deferrals is Lost to the Treasury?

Method Used	Taxes Lost	Taxes Deferred
Treasury Method	83%	17%
Lifetime Method:		
Nominal dollars a/	14	86
Real dollars b/	28	72
Discounted for interest: c/		
at pension rate	40	60
at federal rate	36	64

SOURCE: Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, DC: Employee Benefit Research Institute, 1984).

a/ Before adjusting for inflation.
b/ After adjusting for inflation.
c/ Interest rate used to discount taxes paid in retirement to the year of retirement.

employer. As a result, the only attention given to date to actual per employee cost variation has been undertaken very recently to assess: (1) approaches to health care cost containment and (2) possible disincentives to hiring or keeping on older workers. As illustrated in Table 3, these recent studies show very significant cost variation by age.

Does this cost variation make a tax policy difference? The answer will be yes if employee benefits were to be subjected to income tax or FICA tax. Employees would come to recognize the inequity involved in paying taxes without reference to the true economic value of the benefit being provided. This could lead to demands for taxing based upon the actual dollar value of the benefit provided or a move to tax the benefits paid instead of the premium. This would require a total restructuring of the way in which benefit programs are run.

Present approaches to health insurance pricing and delivery were developed in the present tax environment. A major change in that environment will have a major effect on those approaches and structures. Nearly all of the government and academic research done on this subject to date assumes that a change in tax policy will not change the method of providing or pricing benefits.

Finally, econometric estimates of private health insurance suggest that significant numbers of persons now covered would not choose to purchase health insurance if it was not available from an employer and largely paid for by the employer.

Table 3

Summary of Cost Factors by Age for Use in Costing Benefit Plans

Age Group	Medical Cost Factor as % of Average Cost	Defined Benefit Cost Factor as % of Average Cost	Life Insurance Cost as % of Pay for One Times Pay
Under 30	80.0%	23.0%	0.1%
30-34	80.0%	33.0%	0.1%
35-39	80.0%	48.0%	0.2%
40-44	80.0%	69.0%	0.3%
45-49	100.0%	100.0%	0.6%
50-54	112.5%	146.0%	1.0%
55-59	125.0%	216.0%	1.5%
60-64	160.0%	323.0%	2.3%
65-69	225.0%	*	2.3%

SOURCE: *The Costs of Employing Older Workers* (Washington, DC: U.S. Special Committee on Aging and the Employee Benefit Research Institute, forthcoming).

Note: Same life insurance cost is assumed for 65-69 as for 60-64 because it is assumed that the benefits will be reduced to equal cost; regulations allow a 30% reduction.

If benefits are not reduced, assume costs at 65-69 are about 30% higher.

Defined contribution costs are the same by age.

Conclusion

More than 162 million individuals in this nation gain added economic security from employer-provided employee benefit programs. For example, more than 60 percent of taxpayers have employer-provided health insurance.

Our system of employee benefits has taken decades to build. Tax incentives have been a vital element or force.

Many of these programs meet basic needs. As we seek to reform the tax system we must attempt to draw lines based upon the social and economic value of each current tax preference. Hopefully this statement will help you in that task.

Evaluating Pension-Related Tax Expenditures

By Sophie M. Korczyk

The Congressional Budget Act of 1974 requires that the Administration's annual budget submission to Congress include estimates of tax expenditures. These are personal and corporate income tax revenues lost to the federal government due to provisions in the tax code that allow special treatment for certain sources or uses of income. These estimates are published in an attempt to achieve a symmetry of treatment in the budget process between direct expenditures and the tax expenditures or subsidies that are perceived to flow to certain taxpayers through the tax code.

While the budget process attempts to provide equivalent measures of direct expenditures and tax expenditures, this equivalence is far from perfect. Direct expenditures can be added to arrive at a grand total, they can be tracked over time to determine their trends, and they can be defined fairly clearly (although controversies persist over whether or not certain items, like federal loan guarantees, should be included in the budget rather than being treated separately as they are now).

In contrast, tax expenditures are not additive, they cannot be tracked over time consistently, and their identification is far more problematic than the identification of direct federal spending. Tax expenditures should not be added to arrive at a total because they are interactive. That is, removing a provision costing $5 billion might not add $5 billion to federal revenues because it could encourage more intensive use by taxpayers of another provision aimed at encouraging similar behavior. Tax expenditures cannot be tracked over time because, unlike direct expenditures, there is no process for determining what actual totals were for a given year, and because the measurement of tax expenditures changes over time. Even determining which tax code provisions lead to tax expenditures is controversial, since it requires a judgment about which tax code provisions constitute the basic tax system and which provisions constitute departures from that system and therefore result in subsidies. A further complication arises from the fact that tax expenditures, like direct expenditures, are sensitive to the actual and projected performance of the economy.

Pension-related tax expenditures in the last six federal budgets illustrate some of the problems in measuring, tracking, and interpreting federal tax expenditure statistics. In the 1981 budget, pension-related tax expenditures for fiscal year 1981 were projected at $14.7 billion (table 1). In that year, several personal income tax provisions resulted in larger revenue losses, but by the 1982 budget, pensions accounted for the single largest tax expenditure for individuals. Pension-related tax expenditures grew in the 1982 and 1983 budgets, but jumped precipitously in 1984 with the inclusion of contributions and investment earnings for public-sector plans in the tax expenditure calculations. Public-sector plans are properly included in the calculation since pension participants pay taxes even though their employers may not.

The 1985 budget saw some drop in tax expenditures due in part to the performance of the economy in that year. In the 1986 budget, tax expenditures dropped even below their 1984 level. This drop was due to two factors. First, the performance of financial markets in 1984 along with uncertainty over the regulatory future of pension plans led to a decline in employer contributions. Second, Treasury staff changed the tax expenditure calculation to attribute a share of fund investment earnings to retirees. That share receives tax benefits that should be valued at the retirees' tax rate, which is lower than the tax rate used for active workers.

Even these improvements do not take into account the fact that pensions result in a deferral, not a permanent loss of tax revenues. Because the budget process offsets current tax deferrals against taxes paid by current retirees, it ignores the taxes current workers will pay when they retire. EBRI estimates suggest that workers now beginning their pension careers will repay from $0.60 to $0.82 for every dollar of currently-deferred taxes.

Tax expenditures, in short, are complex and controversial. They rely on some difficult and imprecise concepts. At the same time, the statutory requirement that such estimates be published guarantees that they will play an important role in tax and budget policy debates. Both policymakers and the public should therefore be aware that tax expenditures may be an unreliable basis for making retirement policy decisions.

Table 1

FEDERAL REVENUE LOSS ESTIMATES DUE TO NET EXCLUSION
OF PENSION CONTRIBIUTIONS AND EARNINGS IN
SELECTED FEDERAL BUDGETS

	Fiscal Year						
Budget	1980	1981	1982	1983	1984	1985	1986
	(dollar amounts in billions)						
1981	$ 12.9	$ 14.7					
1982	19.8	23.6	$ 27.9				
1983		23.4	25.8	$ 27.5			
1984			45.3	49.7	$ 56.6		
1985				46.6	50.5	$ 56.3	
1986					44.1	44.3	$ 55.1

SOURCES: Special Analysis G of the Budget of the United States Government for Fiscal Years 1981-1986 (Washington, D.C.: Office of Management and Budget).