EBRI

T-40

Submission On

Tax Reform

For the United States House of Representatives
Committee on Ways and Means

Hearing on Tax Reform and Deficit Reduction
September 25, 26 and 27, 1984

of

Dallas L. Salisbury*
President
Employee Benefit Research Institute

*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.

Dallas Salisbury is President of the Employee Benefit Research Institute, a non-profit, non-partisan, public policy research organization. Before joining EBRI he served in senior career policy research positions at the U.S Department of Labor and the U.S. Pension Benefit Guaranty Corporation. The statement draws heavily from research studies conducted and published by EBRI.

Summary of Statement of Dallas L. Salisbury
President, Employee Benefit Research Institute

- Tax reform is an appealing concept that attracts broad based support when discussed in the context of eliminating abuse. My full statement, and a book now being published by EBRI titled Retirement Security and Tax Policy, discuss the various tax reform alternatives.

- Proposals set forth are characterized by single words: Flat, FAST, consumption, etc. Yet, few on the street fully understand what is involved in obtaining "reform" and "simplification." I hypothesize that few workers who favor "tax reform" understand that many proposals would treat non-cash compensation as taxable income. Would they be less interested in "tax reform" if they did? Action may be appropriate, but an effort should be made to assure clear public understanding if there is to be confidence in the new system.

- Revisions in the tax treatment of employee benefits considered in the context of major tax reform should include several considerations: First - distributional impact - the middle-income worker will be the major victim of any such changes. Second - progressivity desired - some treatments would be more regressive than others. Third - transition - reform would create significant reductions in public welfare and would exacerbate intergenerational tensions. Fourth - simplification - taxing benefits would actually be more complex than the current system. Fifth - the potential revenue gains from taxing benefits should be compared with additional demands that could result on the expenditure side of the budget.

- Federal, state, local and private employer-sponsored retirement plans account for 5.3 percent of total compensation. Three and one-half percent of total compensation finances employer-sponsored group health insurance. Of all full-time employees in medium and large establishments, 82 percent are covered by a pension plan. 96 percent of this group of employees are covered by health and by life insurance plans. Retirement benefit payments exceed $80 billion for a $50 billion tax expenditure, with benefits growing rapidly to complement Social Security. Benefit payments approach $80 billion for a $17 billion tax expenditure.

- The average taxpayer demanding tax reform does not see employee benefits as tax abuse. Rather, both employers and employees see these benefits as part of the social contract that defines how, with the assistance of employers, individuals provide for themselves, their families, and their future. This social contract and related tax benefits affect over 150 million Americans. In 1981, employees earning between $15,000 and $50,000 received 71.8 percent of all health-related tax preferences, 64.5 percent of all pension-related tax preferences, and 67.5 percent of all insurance-related preferences.

- Tax reform is a legitimate policy objective. We must be certain, however, that the "reform" ultimately enjoys greater public suupport than the present system. Inability to achieve this goal with major tax reform may tell us why all industrialized nations have complex tax codes.

CONTENTS

TABLES

INTRODUCTION

Mr. Chairman, I am pleased to submit this statement to the Committee in order to assist it in its discussion of major tax reform options and consequences. My statement primarily focuses on employee benefits. Employee benefits are a key element of the nation's economic security structure, and have been at the center of tax reform discussions. In a recent interview on tax reform, John Chapoton, then Assistant Secretary of the Treasury for Tax Policy was asked to define broadening the tax base. He responded:

> "A lot of income that taxpayers receive today goes untaxed--employer contributions to pension plans, health insurance, free parking, government payments, those benefits....To produce enough revenue, the flat tax would have to apply lower tax rates to more types of income with fewer deductions."[1]

To aid the Congress in considering tax reform proposals, I would like to provide some background on employee benefits, the tax benefits they receive, and the social benefits they provide (see Appendix I). In my testimony today I will discuss:

- The goals of employee benefits;
- Who receives employee benefits;
- Who receives the tax incentives for these programs; and
- The consequences of alternative major tax reform proposals for employee benefits and, therefore, economic security.

The Employee Benefit Research Institute (EBRI) was formed in 1978 as a non-profit, non-partisan, public policy research organization to conduct research and educational programs. EBRI is committed by charter to the premise that the nation is served positively in both social and economic terms by the existence of employee benefit programs; they can be clearly shown to improve economic security. We are aware, however, that there may be limits to what can and should be provided for both social and economic reasons. EBRI undertakes to provide the studies and the statistics that will allow informed priority decisions to be made based upon assessment of documented costs and benefits.

The press release on this hearing stated:

> "Our interest as a Committee is in building a tax system that will be supported by a broad consensus so that the goals of equity and efficient revenue-raising will not be undermined in the years ahead."

Our research indicates that the present tax treatment of retirement, health, and other risk related benefits meets this criterion. The current tax rules meet the Committee criteria of equity, simplicity, balance and economic efficiency. They have broad public support: Social Security, Medicare, Medicaid, employer pensions, employer health, life and disability protection work together to meet a major component of the nation's economic security needs.

These basic benefits are not "tax-ripoffs," are not viewed by the public as "abusive tax-shelters," and are far too significant to be termed "fringes." Further, consideration of the appropriate tax treatment of these benefits should be clearly separated from debates over "consumption fringes."

THE GOALS OF EMPLOYEE BENEFITS

Employer contributions for all public employer, private employer, and social employee benefits in 1982 constituted 15.8 percent of employee compensation according to Department of Commerce estimates (excludes vacation).[2] These payments constitute most workers' main source of protection against the hazards that may keep them from providing for themselves, their families, and their futures. Together, employer contributions for retirement and health programs, including Social Security and Medicare, account for 85 percent of employer payments for benefits.

Retirement Plans. Employer contributions for retirement plans total 9.0 percent of compensation. Federal, state and local and private employer-sponsored retirement plans account for 5.3 percent of total compensation. Contributions for Social Security retirement and disability benefits account for the remaining 3.7 percent.

Health Insurance. Employer contributions for health insurance account for 4.4 percent of total compensation. Of this total, 3.5 percent of total compensation finances federal, state, local and private employer-sponsored group health insurance. The remaining 0.9 percent is accounted for by employer contributions for the Medicare component of the Social Security program.

Other Risks. Employer contributions also finance unemployment insurance, worker's compensation, and life insurance. These programs protect workers and their dependents against economic uncertainty, and death. Payments for these benefits total 2.4 percent of total compensation.

Fringe Benefits. Recent debates over tax legislation have focused on other benefits in addition to the major or traditional categories. The Tax Reform Act of 1984 codified the treatment of benefits like employee discounts and subsidized cafeterias. These benefits are too small as a share of compensation for the Department of Commerce to estimate their value. According to Chamber of Commerce data, these benefits account for 0.6 percent of total compensation.

While traditional benefits make up the largest part of employee benefits, employee benefits have also begun to evolve to meet the needs of the changing work force. Census data show that over the last decade, the proportion of single-adult households with children increased by one-third. Over half of married women are now in the labor force. Single-adult and two-earner households have different benefit needs from those of the traditional single-earner, two-parent family. Many employers now provide child-care benefits, as well as flexible benefit plans that allow single-parent and two-earner families to tailor their benefits packages to meet their specific needs. Cost data on these benefits is not currently available.

WHO RECEIVES EMPLOYER SPONSORED EMPLOYEE BENEFITS?

These benefits are now provided across the income distribution. In medium and large establishments, coverage for major employee benefits is nearly universal. Employee benefits are now a mainstay of the middle-income worker's economic security, building savings as well as providing hazard protection.

Employer Pensions

Of all full-time employees in medium and large establishments, 82 percent are covered by a pension plan (table 1). Small firms, for numerous economic reasons, do not sponsor plans as uniformly. In 1981 the President's Commission on Pension Policy concluded that this could only be changed by mandating plans or by offering tax credits. As firms grow, however, they do add retirement programs. Among employees in all establishments who were covered by pensions in 1983, nearly 28 million (or 59.0 percent) earned less than $20,000 (table 2).

Pensions redistribute wealth to favor those at the lower end of the income scale who do not tend to save much out of current income. According to the EBRI/U.S. Department of Health and Human Services (HHS) May 1983 Current Population Survey (CPS) Pension Supplement, accumulated pension benefits

TABLE 1

Percent of Full-Time Employees Participating in Selected Employee Benefit Programs, Medium and Large Establishments, 1983[a]

Employee Benefit Program	Percent of Employees
Private pension plan	82
Health insurance	
employee	96
dependents	93
Life insurance	96
Long-term disability insurance	45
Sickness and accident insurance	49

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in Medium and Large Firms, 1983," May 1, 1984.

TABLE 2

Distribution of Employees with Pension and Health Coverage by Earnings

Earnings	Employees with Pension Coverage, 1983		Employees with Health Coverage, 1983	
	Total (in millions)	Percent	Total (in millions)	Percent
Less than $20,000	27.9	59.0	83.7	74.3
$20,000 to $49,999	18.1	38.0	26.2	23.2
$50,000 and over	1.4	2.9	2.7	2.4
Total a/	47.4	100.0	112.6	100.0

SOURCE: EBRI tabulations of U.S. Census Bureau Current Population Survey, 1983 and EBRI-HHS Current Population Survey Pension Supplement.

a/ Detail may not add to totals due to rounding. Totals include only those civilian health and pension plan participants who reported their earnings in the Survey. When those not reporting their earnings are added, coverage totals are higher.

constitute the major form of savings for more than half of all persons with pension coverage. More than 40 percent of the labor force reported no savings income in 1983 (table 3). This group's average income was $9,651, just under half the average income of those reporting some asset income. Almost half of the group reporting little or no savings income were covered by employer pensions, however. Pensions thus constituted a net increase in savings for these workers. As the Committee press release noted, assessments of pension-related tax policies should consider the net increase and redistribution of wealth that results from expanded pension coverage.

Not all retirement benefits exhibit the same income distribution patterns, however. In particular, statutory provisions aimed at encouraging individual provision for retirement differ considerably. While 59 percent of pension participants earn less than $20,000, 46.5 percent of individual retirement account (IRA) holders and 34.8 percent of those participating in Section 401(k) plans fell into this income group (table 4). Section 401(k) plans in particular follow a different income distribution from both IRAs and employer-sponsored plans. More than half of Section 401(k) plan participants earn between $20,000 and $50,000, compared with under 50 percent for both IRAs and employer-sponsored plans.

Health Insurance

Of all full-time employees in medium and large establishments, 96 percent are covered by health and by life insurance plans (table 1). Among all employees with employer-provided health coverage, 83.7 million (or 74.3 percent) earned less than $20,000, and 23.2 percent earned between $20,000 and $50,000. About 35 percent of all spending on health care that does not pass through

TABLE 3

Savings, Pension Coverage, and Income, 1983

Savings Status[a]	Employees Covered[b] (Millions)	Employees Covered[b] (Percent)	Employees Not Covered (Millions)	Employees Not Covered (Percent)	Average Annual Income (Dollars)	Average Annual Income (Percent)
No savings	18.2	19.0	20.6	21.5	$ 9,661	40.5
Some savings[c]	36.9	38.4	20.3	21.1	19,209	59.5
Total	55.1	57.4	40.9	42.6	15,338	100.0

SOURCE: Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, D.C.: Employee Benefit Research Institute, forthcoming.

[a]Individuals are classified as having some savings or no savings based on whether or not they reported any asset income in response to the survey questions. Asset income includes interest, dividends, rents, and royalties.
[b]Coverage refers to public- and private-sector pension plans and includes holders of IRA or Keogh accounts.
[c]Includes individuals reporting negative asset income (i.e., decreases in asset values).

Table 4

Percent Distribution of Participation in Retirement Programs, by Earnings, 1983

Earnings	Pension Plan	401(k)	IRA
$ 1 to $19,999	59.0	34.8	46.5
$20,000 to $49,999	38.0	55.7	45.4
$50,000 and over	2.9	9.5	8.0
Number of workers (in millions)	47.4	1.9	16.7

SOURCE: EBRI tabulations of U.S. Census Bureau Current Population Survey, 1983 and EBRI-HHS Current Population Survey Pension Supplement.

government programs is now made through employer-sponsored plans.[3] Fewer than 3 percent of pension and health insurance participants earn more than $50,000.

EMPLOYEE BENEFITS AND THE TAX CODE

The tax code is a major influence in the growth of employee benefits. One effect results from provisions that allow some employer contributions and some employee contributions to finance benefits on a tax-preferred basis. Another major impact stems from the inflation-driven increases in real tax rates of the last 20 years. While statutory tax rates have been falling at most income levels, real tax rates have risen. Inflation has overwhelmed the tax rate cuts enacted over this period. To stem the erosion of real income brought about by this "bracket creep," employees have negotiated compensation packages in which benefits have played an increasingly important role. It is interesting to note, however, that this trend has abated with increasing emphasis on 401(K) salary reduction programs that are subject to FICA tax and employer attention to health care cost-containment.

Employee benefits are also now playing a major role in tax policy. As directed in the Congressional Budget Act of 1974, the President's annual budget submission to Congress lists each year's tax expenditures. These are benefits perceived to flow to certain taxpayers as a result of the statutory treatment of certain sources or uses of income.

Of the 51 tax expenditure provisions that benefit individuals, 20, or nearly 40 percent, affect the tax treatment of privately- and publicly-provided employee benefits. This seems consistent with the nation's commitment to economic security. Two provisions--those governing the tax treatment of employer-sponsored retirement plans and health insurance plans--account for nearly two-thirds of total benefit-related tax expenditures projected in the President's 1985 budget.

Employer pensions account for nearly 50 percent of benefit-related tax expenditures. There is wide disagreement, however, about the proper way to measure these costs. Tax-expenditure measures used in the federal budget process are calculated on a cash-flow or cross-sectional basis, with the taxes deferred by current pension plan participants offset against the taxes paid by current beneficiaries. Measured this way, about $0.83 out of every tax-deferred dollar appears to be lost to the Treasury.

Recent EBRI research, however, suggests that such estimates overstate the amount of revenue lost due to these provisions. Because today's pension-plan participants will have higher retirement incomes than today's retirees, they will pay more taxes in retirement. Over their lifetimes, employees now at the beginning of their pension careers will repay all but $0.25 to $0.40 of every tax-deferred dollar. As the pension system matures, the numbers and income levels of pension-plan participants and retirees will differ less than they do today. As a result, in the future, pension-related tax expenditures measured using the Treasury's approach will be much closer to lifetime estimates.[4]

From the standpoint of long term social and economic policy, however, the difference between tax exemption and tax deferral must always be noted: these programs both reduce demands on Social Security and contribute to the public consensus for Social Security (table 5).

WHO BENEFITS FROM TAX INCENTIVES?

The average taxpayer demanding tax reform does not see employee benefits as a tax abuse. Rather, both employers and employees see these benefits as part of the social contract that defines how individuals provide for

TABLE 5

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

Method Used	Taxes Lost	Taxes Deferred
Treasury Method	83%	0%
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, D.C.: EBRI, forthcoming).

[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.

themselves, their families, and their future. This social contract and related tax benefits includes the majority of the U.S. labor force.

The distribution of benefit-related tax benefits among income groups reflects the distribution of coverage and participation. In 1981, employees earning between $15,000 and $50,000 received 71.8 percent of all health-related tax preferences, 64.5 percent of all pension-related tax preferences, and 67.5 percent of all insurance-related preferences (calculations based on table 6). This group pays 51 percent of total federal taxes. By comparison, this income group received 64.2 percent of tax benefits related to homeownership. It would seem that employee benefits are less of a luxury than owning your own home.[5]

TABLE 6

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	6.7	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, Revising the Individual Income Tax, 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.

THE TAX REFORM MOVEMENT

Tax reform is a perennial topic of discussion. At least a dozen major tax reform proposals were introduced in the 97th Congress. More tax reform proposals were introduced in the 98th Congress. Some legislative proposals call on the Treasury to study major tax reform, while others contain detailed amendments of the Internal Revenue Code. President Reagan has also asked that the Treasury department analyze basic tax reform options and prepare a report by December 1984.

At the heart of the major tax reform movement is the widespread belief that the tax system is unfair and inefficient. The middle-income taxpayer feels that he or she is paying the bill for the loopholes of the wealthy.

The tax system is considered by some to be inefficient because investment and other economic decisions are often driven as much or more by tax needs as by economic returns and productivity considerations. High marginal tax rates encourage taxpayers to seek out tax-favored sources of income--capital gains, for example--and tax-favored uses of income, such as housing.

Major tax reform proposals offer ways to restructure--not lower--the nation's tax bill. Major tax reform proposals such as the flat tax, the "fast" tax, the consumption tax, and the gross income tax, would lower marginal tax rates and expand the income tax base. These proposals would change the distribution of tax liability among individuals by eliminating many tax preferences in current law. Another set of proposals would raise additional revenue through a broad based value added or sales tax.

The arguments for broadening the tax base have attracted a wide range of political support. Conservatives support broadening the tax base as a way of eliminating the income-earning disincentives and market interference of high marginal tax rates. They also prefer individual decision-making to employer or government decisions made on the worker's behalf. In this view, Individual Retirement Accounts (IRAs) are preferable to either Social Security or employer pensions as a means of providing for retirement.

Liberals support broadening the tax base as a way of eliminating tax-code provisions perceived to benefit primarily the rich. They also prefer direct government expenditures over the tax subsidies that might arise from tax incentives.

EMPLOYEE BENEFITS IN MAJOR TAX REFORM PROPOSALS

While tax reform has broad support, it would also have widespread costs. One of the most important consequences of tax reform proposals that seek to restructure the tax system for the average taxpayer would be to change the tax treatment of employer contributions for employee benefits.[6]

Comprehensive Income Tax

A comprehensive tax attempts to tax both actual and imputed income. Many comprehensive income tax proposals include in taxable income not only cash wages but also all or most employer contributions for employee benefits on a current basis.

Consumption Tax

The consumption tax would tax all income that is spent, excluding saving from taxable income until the funds were used for consumption. The consumption tax would therefore tax all employer contributions for benefits that do not result in saving. This includes the various employee benefits that provide insurance protection, like health insurance plans, life insurance, and disability insurance. Since cash compensation would continue to be a tax-deductible cost of doing business to the employer, the employer would presumably have an incentive to offer more compensation in cash than in benefit contributions.[7]

Value-Added Tax

For any one employer, value added is the difference between receipts from sales and amounts paid for materials, supplies, and services purchased from other firms. Total value added for the entire economy is equal to total wages, salaries, interest, rents, and profits. Like the current income tax, the value-added tax could include or exclude employee benefits in the tax base.

Federal Sales Tax

A federal sales tax would have the same effect as some forms of the value-added tax. The difference is that a federal sales tax would be levied at the point of sale, while a value-added tax is imposed at each stage of production. Since a sales tax imposes tax liability on the total value of the product, it would implicitly tax employer outlays for employee benefits since these outlays are a cost of production. It would likely have little effect, however, on either employer or individual behavior regarding the provision of employee benefits.

ISSUES IN IMPLEMENTATION AND TRANSITION

This committee expressed an interest in implementation and transition issues in basic tax reform. These problems could be formidable, and even predicting them involves some uncertainty about the reactions of employers, employees, and insurers and other providers of benefits. This uncertainty arises from the fact that the availability of tax incentives for employee benefits has influenced how plans are provided and designed. For example, because employee benefits are purchased on a group basis, employers and employees can benefit from economies of scale. Therefore, a dollar spent on employee benefits by an employer buys more than would the same dollar spent by an individual. In the absence of tax incentives encouraging employer provision, the administrative structures that make group purchases cost-effective may never have been developed.

Alternative treatments for employee benefits that have been proposed include:

- o Including benefit contributions in the employee's adjusted gross income;
- o Eliminating employer deductions for benefit contributions;
- o Capping the share of total compensation that can be provided in the form of tax-favored employee benefits;
- o Imposing an excise tax on the employer's benefit contributions; and
- o Imposing a value-added or national sales tax.

The issues and economic effects that arise under each approach differ considerably.

Including Benefit Contributions in Adjusted Gross Income

Most plans do not determine the costs of employee benefits on the basis of the characteristics of the individual for whom protection is being provided. These pricing structures are reasonable from employer's viewpoint given current tax treatment, since the total cost of insuring the employer's work force is not affected by the allocation of these costs among the members of the covered population. They are irrelevant to the employee who cares only about the total amount of insurance provided, and not about how the cost of this insurance is billed to the employer.

If employer contributions for benefits were taxed to the employee, the entire pricing and cost allocation structure of benefit plans could have to be revised to allocate contributions appropriately among individuals. While the average price of providing employee benefits to various employees may be uniform, the underlying cost of benefits differs widely according to the employee's age under all major benefits. Benefits for younger employees are less costly because these employees generally have lower health insurance claims, disability rates, and mortality rates. The adjustments that would be required would vary across benefits.

Pensions. Actuarial methods used in defined-benefit pension plans do not generally allocate contributions or projected benefits to individuals, determining them instead for an employee cohort based on aggregate forecasts of that cohort's future demographic and economic experience. If defined-benefit pension costs were allocated among individuals, it would become clear that financing a given retirement benefit requires a lower contribution for a younger employee than for one closer to retirement age. The contribution for the younger employee can accrue interest over a longer period of time, while the same benefit increment for an older employee has to be financed primarily out of employer contributions.

Pension costs in a defined-benefit plan may therefore be 14 times as high for an employee at age 60 as at age 30 (calculations based on table 7). Attributing an average pension contribution to each employee would create serious inequities. Older employees would be undercredited, while younger employees would be overcredited. To the extent that older employees earn more and are taxed at a higher rate than younger employees, this inequity would be compounded.

Health Insurance. Employer contributions to finance health insurance are similarly based on the total cost of insuring a particular employee group.[8] Underlying costs for health insurance can be twice as high at age 60 as they are at age 30 (calculations based on table 9). Similarly, the underlying cost of providing health insurance for women of child-bearing age is higher than the cost of insuring young, single men. In short, the average price of most employee benefits is much higher than the cost of providing benefits to some individuals and much lower for others.

Options for Alternative Tax Treatment

If employer contributions for benefits were included in the tax base, they might be treated in the same way that the Internal Revenue Code now treats employer-paid life insurance premiums for coverage in excess of $50,000. These premiums are currently included in the tax base. The cost of life insurance varies according to the individual's age. For example, at age 30, the cost of providing life insurance worth an individual's annual salary is 17 percent as large as it is at age 45, while at age 60 this cost is nearly 4 times as large (calculations based on table 7).

To avoid the inequities that would arise if all individuals were taxed on an average cost of insurance, Treasury regulations prescribe the amount of premiums to be recognized as income for individuals on the basis of age (in five-year brackets) and coverage levels. The Treasury tables use blended actuarial assumptions for men and women based on the proportions of men and women in the group of employees with coverage over $50,000 in value.

To achieve an equitable distribution of tax liability, a schedule like that governing the tax treatment of life insurance would probably have to be developed for all employee benefits. Given the Supreme Court's decision in the Arizona v. Norris case, such tables would probably not be differentiated by sex. Such tables could, however, be differentiated by age, family status,

TABLE 7

BENEFIT COST FACTORS FOR EMPLOYEES
AT VARIOUS AGES

Age Group	Medical Cost Factor as % of Cost at Age 45-49	Defined-Benefit Cost Factor as % of Cost at Age 45-49[a]	Life Insurance Cost Factor as % of Cost at Age 45-49[b]
Under 30	80.0	23.0	17.0
30-34	80.0	33.0	17.0
35-39	80.0	48.0	33.0
40-44	80.0	69.0	50.0
45-49	100.0	100.0	100.0
50-54	112.5	146.0	170.0
55-59	125.0	216.0	250.0
60-64	160.0	323.0	383.0
65-69	225.0	c	383.0

SOURCE: Anna M. Rappaport, F.S.A. and Malcolm H. Morrison, Ph.D., The Costs of Employing Older Workers (Washington, D.C.: U.S. Senate Special Committee on Aging and the Employee Benefit Research Institute, forthcoming).

[a]Defined contribution plan costs do not vary by age.
[b]Same life insurance cost is assumed for 65 to 69 as for 60 to 64 because it is assumed that the benefits will be reduced to equal cost; regulations allow a 30 percent reduction. If benefits are not reduced, assume costs at 65-69 are about 30 percent higher. Figures assume life insurance provided is worth one times pay.
[c]Pension costs for these employees depend on the plans's design.

==

or both. Family status could be used to predict health insurance claims under plans that offer maternity or dependents' benefits.

Effects of Taxing Benefits

The effects of taxing benefits would vary among benefits and would depend on whether or not individuals chose to continue their coverage. If pension accruals were taxed on a current basis, saving would almost certainly decline, and would decline disproportionately among those at lower income levels who do not tend to save out of current income.

To avoid the added tax liability, many low- and moderate-income individuals would choose to do without health and other types of insurance. Research conducted by the Employee Benefit Research Institute (EBRI) and others indicates that income determines whether or not people without employer-provided health coverage purchase such coverage themselves. If employers did not provide health coverage, most low-income workers would not purchase private health insurance.[9] Since most people covered by an employer health plan are members of low- and middle-income families, employer-provided health benefits probably substantially raise rates of private health insurance coverage throughout the nonelderly population.

For those who chose to continue their insurance coverage, the impact of a tax on health insurance premiums would be regressive. While employer contributions for life and disability insurance are based on the employee's earnings, contributions for health insurance are not. As a result, the value of employer-provided coverage is a larger share of total compensation at lower income levels and the added tax payment of low-income workers would be a larger share of their income than at higher income levels. EBRI tabulations of data produced by the Congressional Budget Office (CBO) indicate that under the Administration's proposal to cap the amount of health insurance premiums that an employee can receive tax-free, those with the lowest incomes would pay more than six times as much tax as a percent of income as those with incomes above $50,000.[10]

The flatter rate structure of some major tax reform proposals would exacerbate this regressivity. Under current-law rates, the progressivity of the tax schedule offsets the effect on tax liability of the declining share of health insurance in compensation at higher income levels.

In short, whatever the criterion used for determining the cost of each employee's cost of benefits, if it targeted those individuals likely to have the highest incidence of claims, it would also target those most likely to need insurance. Since those most likely to become sick, disabled, or die would face the highest tax liability, taxing employer contributions for benefits would impose tax liability in inverse proportion to ability to pay.

Another potential effect of taxing employee benefits to the individual could be to increase the attractiveness of flexible compensation or cafeteria plans. Under flexible compensation plans, employees can elect various levels of coverage under the major types of employee benefit plans. An employee choosing a less-generous health insurance plan, for example, can "spend" the employer's cost savings on added life insurance, vacation days, or other benefits. All employees--except for those who chronically guessed wrong about their need for health insurance or other benefits--would segregate themselves into plans according to the expected value of their claims. While this is the fundamental principle behind flexible compensation plans, many employers sponsoring these plans now price the high-cost insurance options at less than the value of the claims expected under them to maintain a reasonable risk pool of participants under each option. If employees were being taxed on the value of employer contributions, however, such subsidies would probably have to stop, since they would mean that low-risk employees would be paying the tax bill for higher-risk persons. If all persons chose plans priced at the expected value of their claims, the risk-sharing inherent in group insurance plans would be eliminated.

Eliminating Employer Deductions for Employee Benefits

Some of these distributional problems could be avoided in major tax reform proposals that would include nonpension employee benefits in the tax base by eliminating employer tax deductions for them. The value-added tax could have this effect, depending on how it was designed, and some versions of the consumption tax would provide for this.

Faced with such a provision, employers who now offer benefits would probably cut them back and those who do not would probably not institute them. Some employers who offer benefits might eliminate them or continue to offer them with full employee payment. Others might forego improving their benefit packages, while still others might institute or increase employee contributions, deductibles, or copayments where appropriate. Employers are already working to reduce their benefit costs; including benefits in the tax base would clearly accelerate this process but at a social cost.[11]

The greatest impact of proposals to eliminate employer deductions for benefits would probably be on those employees who are not now covered. Most employees without benefit coverage tend to be in smaller firms and at lower income levels. As small and new firms grow and become profitable, they are more likely to incur the financial commitment involved in establishing employee benefit plans. Removing the tax deductions for employee benefits would probably make this commitment uneconomical.

Capping Employee Benefits as a Share of Total Compensation

Another alternative that has received some attention in tax policy debates--though not necessarily in the context of major tax reform--is establishing a limit on the share of total compensation that can be provided in the form of tax-favored employee benefits. Benefits provided in excess of this amount would be subject to payroll tax, income tax, or both. Under alternative proposals, the cap could cover contributions for all benefits, or pensions, welfare benefits, and so-called "fringe" benefits could all be capped separately.

Such an approach could raise its own set of problems. For example, an employer with a mature, long-tenure work force could be put at a competitive disadvantage compared with an employer with a younger work force, even if the benefits in the two firms were identical. Furthermore, a cap could act as a target that firms with less-generous benefit plans would feel compelled to meet to maintain their competitive positions. The efforts of such employers to catch up could offset the effects on employers whose benefits exceeded the cap. Such a system could also be difficult to implement for non-profit or public-sector employers, neither of which pay business profit taxes.

Of the four alternatives that tax reformers have proposed, however, only the national sales tax would offer employers and employees more flexibility than the tax cap to choose among benefits and to choose the level of coverage to be provided under major benefits. Establishing a tax cap, however, would point up the difference in the tax treatment of insurance provided under the employer's auspices compared with the treatment of insurance purchased by the individual directly. While persons without pension coverage can establish IRAs on a tax-preferred basis, those without health or other insurance pay for such protection with after-tax dollars. A tax cap combined with provisions allowing individual purchases of insurance with before-tax dollars could mitigate the detrimental effects on expansion of coverage that could result from taxing employer contributions for benefits.

An Excise Tax on Benefits

Rather than capping benefits as a share of compensation, it would be possible to impose an excise tax on all tax-favored benefits, whatever their level. This was proposed by the Treasury to this Committee in Testimony of June 1983. This would avoid creating a target benefit level for employers to reach. An excise tax, however, would have the same effect on benefits as eliminating employer deductions for benefit contributions. Employers now offering benefits would cut them back, while those without benefits would probably not institute them. The only difference between the two options would be in the tax rates they would impose. If an excise tax carried lower rates than the corporate or business taxes the firm might be paying, then the incentives to eliminate benefits would not be as strong.

A Value-Added or National Sales Tax

Instituting a national sales tax or a value-added tax would not have the same effect as a tax levied specifically on benefits. Any tax levied at the point of sale or at different stages of production would be neutral between wages and benefits as a form of compensation and thus would not change employer and employee preferences.

CONCLUSIONS AND POLICY IMPLICATIONS

Basic tax reform appeals to a broad constituency. Current and projected deficit levels pose a threat to the economy; it may be that only sweeping changes in the tax structure will allow the federal government to raise adequate revenues to eliminate this threat.

The basic tax reform movement is motivated in part by the erosion of the income tax base due to the proliferation of both business and individual tax preferences. As the Congress proceeds with these discussions, it will be confronted with representatives of almost every special interest that benefits from the 106 provisions in the code that lead to tax expenditures, and whose elimination could hurt the pocketbooks of these interest groups. One group will probably not be represented in these discussions, however. The average working person, who takes for granted the health, pension, and insurance benefits provided in his or her compensation package, almost surely does not think of employee benefits as a tax loophole.

The Congress, however, is charged with taking a perspective on these issues that transcends the concerns of special interest groups. In particular, it is essential that major tax reform debates look beyond revenue-raising considerations alone and examine the broader economic implications of eliminating incentives now built into the tax code.

Many of these incentives were designed to further social and economic goals that could not be efficiently pursued through the expenditure side of the budget. The elimination of these incentives in the name of short-term budget goals could lead to much higher costs for the federal government in the future. When compared with the costs of assuring economic security through direct federal spending, tax incentives for employee benefits may turn out to be a bargain. For example, according to Department of Commerce data, employer-based pensions now provide over half as much retirement income as the Social Security program.[12] If employer pensions were eliminated and Social Security benefits were to be increased by 50 percent, the deficit projected in the President's budget proposal would have been almost 60 percent higher. Could the economy sustain such an increase?

Tax incentives for health insurance raise similar issues. Tax expenditures attributed to the tax exemption of employer contributions to health insurance were estimated at $17.6 billion in 1984.[13] This may be a relatively low price for society to pay for a system of health insurance that may pay as much as $90 billion in benefits in 1984 and serves more than 60 percent of the population. In 1984, by comparison, federal spending for Medicare is expected to total $62.2 billion dollars; federal-state spending for Medicaid is estimated at $37.8 billion.[14] Together, these public programs finance health care services for only about 18 percent of the population.

In any revisions of the tax treatment of employee benefits, several considerations should be prominent. First - distributional impact - the middle-income worker will be the major victim of any such changes. Second - progressivity desired - some treatments would be more regressive than others. In particular, including benefit contributions in the individual's adjusted gross income is the option that would most disrupt the arrangements now used for providing benefits and could also result in the most regressive redistribution of tax liability and benefit coverage. Third - transition - would create significant reductions in public welfare and would exacerbate intergenerational tensions. Fourth - simplification - taxing benefits would actually be more complex than the current system. Finally, the potential revenue gains from taxing benefits should be compared with additional demands that could result on the expenditure side of the budget. Once such a comparison is made, the tax code could prove to be a very efficient means of encouraging private provision for individual economic security.

NOTES

[1] "Our Complex Tax Laws: Can They Be Reformed?" U.S. News and World Report, July 30, 1984.

[2] This total includes Social Security contributions; unemployment insurance; workmen's compensation; private pensions and profit-sharing plans; federal, state and local government employee retirement plans; group health insurance, group life insurance; and supplemental unemployment benefits.

[3] Unpublished EBRI estimate.

[4] For further detail on these estimates, see Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, D.C.: EBRI, forthcoming), Chapter IV.

[5] EBRI calculations based on U.S Congress, Congressional Budget Office, Revising the Individual Income Tax (Washington, D.C.: U.S.Government Printing Office, 1983), Table 9.

[6] Alternative tax systems would require detailed judgments about the treatment of various sources and uses of income. Both would also create some formidable implementation and transition problems. These problems and issues are treated in detail elsewhere. For a discussion of employer pensions in basic tax reform, see Sophie Korczyk, Retirement Security and Tax Policy (Washington, D.C.: EBRI, forthcoming) and "Basic Tax Reform: Implications for Employee Benefits," EBRI Issue Brief no. 28, March, 1984. For a wide-ranging discussion of theoretical and practical issues in basic tax reform, see Dallas L. Salisbury, ed., Why Tax Employee Benefits? (Washington, D.C.: EBRI, 1984).

[7] This argument is advanced in Robert E. Hall and Alvin Rabushka, Low Tax, Simple Tax, Flat Tax (New York: McGraw-Hill Company, 1983), p. 90.

[8] In smaller plans, the cost of providing health insurance for the marginal employee is based on the average costs of insuring the insured population of that community. In larger plans, the cost of insuring the marginal employee is based on the average cost of insuring the population represented by that employer's work force. While these two methods would be likely to yield different insurance costs for any given employee, under either method the cost of insuring that employee does not represent the cost of that employee's expected claims.

[9] Deborah J. Chollet, Employer-Provided Health Benefits: Coverage, Provisions, and Policy Issues (Washington, D.C.: Employee Benefit Research Institute, 1984), p. 94. An EBRI simulation of private health insurance suggests that 56 to 87 percent of all covered workers with 1979 family income less than $15,000 would not have purchased private health insurance, if an employer had not offered and contributed to their health insurance plan.

10 Deborah J. Chollet, Employer-Provided Health Benefits: Coverage, Provisions and Policy Issues, p. 100. For a discussion of taxing employer contributions to health insurance, see also "Revising the Federal Tax Treatment of Employer Contributions to Health Insurance: A Continuing Debate," EBRI Issue Brief no. 21, August, 1983.

11 For a discussion of employer efforts to reduce health care costs, see "Controlling the Cost of Health Care: Recent Trends in Employee Health Plan Design," EBRI Issue Brief No. 23, October, 1983.

12 In 1981, the latest year for which complete data are available, Social Security Old Age, Survivors', and Disability benefits were $138.6 billion,, while private-sector and federal, state, and local government retirement plan benefits were $73.2 billion.

13 Budget of the U.S. Government, Fiscal Year 1985, Special Analysis G.

14 Deborah J. Chollet, "Assuring Economic Security for Workers: Health, Disability, and Life Insurance Benefits," Statement before the United States Senate Finance Committee, Subcommittee on Taxation and Debt Management, Hearing on Fringe Benefits, July 26, 27, and 30, 1984.

EBRI Research Related to Major Tax Reform

Books

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

Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, D.C.: EBRI, forthcoming), Chapter IV.

Dallas L. Salisbury, ed., Why Tax Employee Benefits? (Washington, D.C.: EBRI, 1984)

Shorter Papers

"Basic Tax Reform: Implications for Employee Benefits," EBRI Issue Brief no. 28, March, 1984.

"Revising the Federal Tax Treatment of Employer Contributions to Health Insurance: A Continuing Debate," EBRI Issue Brief no. 21, August, 1983.

"Controlling the Cost of Health Care: Recent Trends in Employee Health Plan Design," EBRI Issue Brief No. 23, October, 1983.

Deborah J. Chollet, "Assuring Economic Security for Workers: Health, Disability, and Life Insurance Benefits," Statement before the United States Senate Finance Committee, Subcommittee on Taxation and Debt Management, Hearing on Employee Fringe Benefits, July 26, 27, and 30, 1984.

APPENDIX I

For legislative policy assessment purposes benefits can be classified into at least nine categories:

1. legally required benefits (including employer contributions to Social Security, Medicare, unemployment insurance and workers' compensation insurance);

2. discretionary benefits that are fully taxable (primarily, payment for time not worked);

3. discretionary benefits that insure the employee against financial risks and are tax exempt (including employer contributions to health, life, and disability insurance plans);

4. discretionary benefits that help the employee meet special needs and are tax exempt (including employer contributions to child care and legal plans);

5. discretionary benefits that have traditionally been called fringes and are intended to meet employer needs and are tax exempt (including employer provision of purchase discounts, job site cafeterias, special bonuses and awards, van pools, clubs, and parking);

6. discretionary "reimbursement account" benefit programs that have been legally allowed since 1978 which allow employees to have reimbursement accounts--funded by the employer or through salary reduction--to pay expenses that fall into "statutory benefit" areas and are tax exempt (including health care reimbursement, child care reimbursement, etc.);

7. discretionary benefits that provide retirement income as a stream of payments and for which taxes are deferred until benefits are received (including employer contributions to defined benefit pension plans and to defined contribution plans which require payment in the form of an annuity);

8. discretionary benefits that provide for the deferral of salary until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, to money purchase plans and ESOPs); and

9. discretionary benefits that provide for the deferral of salary until special needs arise (loans and hardship), or until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, thrift-savings plans, and salary reduction plans).

During a time when there are no apparent limits on direct federal expenditures, or on "tax incentives," analysis may not need to focus on the diversity of employee benefits. During a time of apparent limitations, however, when priorities must be decided upon, careful analysis is required of each employee benefit: why each employee benefit exists.

* Taken from a statement on EMPLOYEE BENEFITS AND ECONOMIC SECURITY by Dallas L. Salisbury before the United States Senate Finance Committee Subcommittee on Taxation and Debt Management hearing on Employee Fringe Benefits, July 26, 27, and 30, 1984.