Why Tax Employee Benefits

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Employee Benefit Research Institute

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Edited by
DALLAS L. SALISBURY

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Foreword

Employers and employees, public and private, have consistently placed a high value on employee benefits. Many benefits, such as holidays and other time off, are fully taxed. The government has encouraged the growth of other benefits through tax incentives. Concern over low rates of private health insurance and pension coverage among workers in the past, even with tax incentives, has generated discussions of national health insurance and mandatory private pensions.

In recent years the federal tax laws have been changed in ways that significantly affect employer-sponsored programs and individual programs. In 1981, the Economic Recovery Tax Act (ERTA) expanded the availability of individual retirement accounts (IRAs). In 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) changed, among other things, contribution limits, top-heavy provisions and pension plans. The 1983 Social Security Amendments subjected section 401(k) and 403(b) benefits to the payroll tax.

These and earlier provisions of the U.S. tax code have been the subject of much discussion over the years. The dialogue twenty or thirty years ago focused on expanding benefits; the dialogue ten years ago focused on making benefits more secure. Recently, the dialogue has centered on the impact that favorable tax provisions for employee benefits have had on the federal tax collections.

The Issue of Federal Deficits

The discussion of the tax treatment of employee benefits has heated up for several reasons. First, federal deficits of $200 billion are looming before us; there is no parallel in U.S. history for deficits approaching this magnitude.

The first evidence of national concern over these deficits and the implication for employee benefits was embodied in TEFRA. Central to the debate over TEFRA was "revenue enhancement," a new government-speak term meaning increased taxes.

But, TEFRA was not a traditional tax increase—an increase in the tax rate—but rather a subtle adjustment to a fairly complicated code. Adjustments to the tax provisions for employee benefits, especially pensions, were not broadly perceived in the popular press or among the public as having negative implications for rank-and-file workers.

The debate over the Social Security Amendments, the deliberations of the National Commission on Social Security Reform, the debates in the

Congress, and the discussion of subjecting section 401(k) plans and other employee benefits to the payroll tax clearly indicated that this was a revenue issue. Senator John Heinz (R-Pennsylvania), for one, spoke often and eloquently on the problems of tax "leakage." And, in the health care debate, the discussion of tax caps is often revenue directed, either in terms of overall budget deficits, or the need for new revenues to finance health benefits for unemployed persons.

The Increase in Tax Expenditure Estimates in the Budget

The second reason the tax treatment of employee benefits has aroused more discussion lately lies in the estimated tax expenditures in the 1984 budget. Pension tax expenditures were estimated at $25.8 billion in the 1983 federal budget; but those same tax expenditure items for 1983 were reestimated at $43.5 billion in the 1984 federal budget—an increase of 75 percent for the same year, without a word of explanation. The change in the estimate was not a total revision of the number that had been projected in 1983; the change primarily reflected the addition of state and local workers and federal civilian workers into the estimate.

The action raised this category of pension tax expenditures from one of the larger tax expenditures in the menu of items presented each year in the budget to a position of preeminence as by far the largest item in the menu now. At the same time, the estimated IRA tax expenditure numbers remained stable between the 1983 and 1984 budgets, although it was clear that the contributions to IRAs had exploded during 1982.

Budget tax expenditure estimates caught up with reality in the 1985 budget proposal, however. Tax expenditures for IRAs and Keoghs in the 1985 budget were three times the size of the estimates in the 1984 budget.

CBO's Analysis of Federal Pension Laws

This rising concern about the tax treatment of benefits prompted a special request early in 1983 from Senator Robert Dole, Chairman of the Senate Finance Committee, to the Director of the Congressional Budget Office (CBO), for an analysis of "Public Policy Toward Private Pensions." The CBO study is currently in progress.

Taxation of Fringe Benefits and Tax Expenditures

Without question, the federal government must specify which employee benefits should be tax favored. Great care, however, must be taken to

avoid unintended consequences. Consideration of changes in tax policy must include a clear definition of objectives, an assessment of individual benefits in relation to these objectives, and, finally, a more thorough understanding of the tax and social effects of each benefit. This process can be effective only if analysts understand the distinction between mandated versus voluntary benefits, fully taxed versus tax-favored benefits, and tax-exempt versus tax-deferred benefits. Most analyses and debate in recent years have not made these distinctions.

With these issues and informational needs in mind, the Employee Benefit Research Institute (EBRI) held a public policy forum on "The Tax Treatment of Employee Benefits: Yesterday, Today and Tomorrow" in June 1983. Since that session, the debate over tax questions has intensified—a trend that is likely to continue.

This book is based on the June 1983 policy forum. It begins with a background and overview chapter prepared by EBRI staff which describes the nature, costs, and benefits of employee benefit programs. Additionally, it discusses issues related to the government's estimates of tax expenditures attributable to benefit programs.

The book then follows the flow of the policy forum and includes edited papers and questions and answers elicited by each presentation.

On behalf of EBRI, I wish to thank all of those who worked so hard to make the policy forum possible: EBRI staff, the authors, and the diverse group of participants.

Views expressed in this book are solely those of the authors. They should not be attributed to the officers, trustees, members or associates of the Employee Benefit Research Institute, its staff, or its Education and Research Fund.

DALLAS L. SALISBURY
President
February 6, 1984

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Mr. Smith is currently Director of Special Projects, Corporate Human Resources at the Sun Company, Inc. He began working for the Sun Oil Company in the 1950s after a few years on the faculty at Bucknell University. His job titles at the Sun Company have included Director of Human Resources, Vice President, and Director of Compensation and Benefits.

About the Policy Forum and This Report

To explore the growing concerns about the effects of potential changes in the tax treatment of employee benefits, the Employee Benefit Research Institute (EBRI) invited representatives of government, business, labor, research groups, and the media to attend a policy forum, "The Tax Treatment of Employee Benefits: Yesterday, Today, and Tomorrow." The forum took place on June 8, 1983, in Washington, D.C. EBRI's President, Dallas L. Salisbury, moderated a panel discussion by five distinguished experts on various aspects of the forum topic. A list of the 96 forum participants, many of whom contributed to the discussion, appears in Appendix A.

Everett Allen, Jr., discussed the effects of increasingly complex tax policies, the administrative burdens imposed on private benefit plans, the problems associated with the new emphasis on defined-contribution plans, and the section 415 limitations. He made a plea for national policymakers to nurture the private employee benefits system.

Harry Smith talked about the reasons that employers provide benefits and the influence of tax treatment on employer decisions. Focusing on the Sun Company's pension plan, he also addressed the question of integrating private plans with Social Security.

Michael Melton pointed out the reasons for the special provisions for benefits in the U.S. tax code and cited social goals as justification for special treatment of retirement benefits. He proposed a number of radical and not-so-radical solutions to the "upside-down" subsidy reflected in the use of individual retirement accounts (IRAs).

Daniel Halperin discussed the utility of a flexible approach to taxable and nontaxable compensation and the value of ceilings on tax-excluded compensation.

Paul Ginsburg speculated on the potential effects of changes in the tax treatment of employers' health insurance contributions—including the reduced comprehensiveness of employer-paid health insurance, increased cost sharing, and uneven effects among individuals and regions.

The discussion that followed each presentation covered topics ranging from the extent to which workers will participate in the debate over benefits, to the revision of regulations and the threatened termination of benefit plans, the need for fundamental tax reform, and the fragility of revenue estimates. Panelists concluded the program with summary comments on the appropriate future tax treatment of employee benefits.

This report includes the edited forum proceedings. It also includes a selected chronology of legislation dealing with the tax treatment of employee benefits which appears in Appendix B.

Background on the Tax Treatment of Employee Benefits: An Overview of the Issues

Deborah J. Chollet

The growth of employee benefits as a form of employee compensation has attracted increasing attention in recent years chiefly because of a concern that the growth of benefits occurs at the expense of growth in wage and salary income. Slower growth of wages and salaries, in turn, implies slower growth of the tax base. Erosion of the tax base affects the public sector's ability to finance government programs in general and the Social Security system in particular. In addition, growth of nontaxable benefits may imply an important redistribution of the tax burden across the population. These effects of growth in employee benefits, and in tax-exempt benefits in particular, merit careful attention.

As background to these important policy questions and the papers presented at the forum, this section sets out to accomplish three things: (1) present a basic description of the composition, size and growth of tax-favored employee benefits; (2) provide an explanation of the techniques used in estimating the tax expenditures for tax-favored retirement programs, and appraise the usefulness of tax expenditures in formulating federal tax and retirement policies; and (3) discuss proposals to reform tax preferences for health insurance, their likely impact on the generosity and rate of health insurance coverage, their impact on federal tax revenues and tax burdens, and their effectiveness in containing national health care costs.

Description of Tax-Favored Employee Benefits

The Composition of Employee Benefits—Possibly the most often-quoted figures on the level and growth of employee benefits are those compiled by the Chamber of Commerce of the United States. The figures are based on responses to an annual survey of a small number of employers (fewer than 1,000); the employer sample is not scientifically selected, and it is not weighted to be representative of true national totals. Nevertheless, estimates based on these data capture a picture of the general distribution of employee benefits among: (1) legally required employer payments; (2) fully taxable employee benefits; and (3) tax-favored employee benefits. Disaggregating the total level of employee contributions

TABLE 1
Composition of Employee Benefits by Benefit Group, 1982

Benefit Group	Employer Payments as a Percentage of Wages and Salaries	Employer Payments as a Percentage of All Benefits
Total Benefit Payments	32.5	100.0
Legally Required Employer Payments:	9.5	29.2
Social Security (FICA)	5.2	16.0
Unemployment Compensation	1.1	3.4
Workers' Compensation	0.9	2.8
Other Legally Required Payments[a]	2.3	7.1
Discretionary Taxable Benefits:	13.9	42.8
Time Not Worked[b]	9.8	30.2
Rest Periods	3.8	11.7
Other Taxable Benefits[c]	0.3	0.9
Discretionary Tax-Favored Benefits:	9.0	27.7
Contributions to Pension and Profit-Sharing Plans[d]	4.0	12.3
Group Health, Life, Short-Term Disability Insurance	4.4	13.5
Other Tax-Favored Benefits[e]	0.6	1.8
Summary:		
Legally Required Employer Payments and Discretionary Taxable Benefits	23.5	72.0
All Discretionary Benefits	23.0	61.5
Fully Taxable Benefits	13.9	42.8
Tax-Favored Benefits	9.0	27.7

Source: EBRI tabulation of U.S. Chamber of Commerce estimates in *Employee Benefits 1982* (Washington, D.C.: U.S. Chamber of Commerce, 1983), pp. 11 and 28.

[a]Includes government employee retirement, Railroad Retirement Tax, Railroad Unemployment and Cash Sickness Insurance, and state sickness benefits insurance.
[b]Includes paid vacations and payments in lieu of vacation; payments for holidays not worked; paid sick leave; payments for State or National Guard duty; jury, witness, and voting pay allowances; and payments for time lost because of death in family or other personal reasons.
[c]EBRI estimate based on Chamber of Commerce report of amount of Christmas or other special bonuses, service awards, suggestion awards, special wage payments ordered by courts, and payments to union stewards.
[d]EBRI tabulation of Chamber of Commerce estimate of employer contributions to profit-sharing plans.

reported in the Chamber of Commerce data among these three groups clarifies the magnitude of tax-base erosion that can be attributed to the growth of employee benefits.

According to the Chamber of Commerce data, employer contributions to employee benefits exceeded 32 percent of wages and salaries in 1982. Nearly three-fourths of this figure (23.5 percent of wages and salaries) represented either legally required employer payments (9.5 percent of wages and salaries) or discretionary employer payments (13.9 percent of wages and salaries) that are fully taxable (see table 1). Legally required employer payments include contributions for Social Security, unemployment compensation insurance, workers' compensation insurance, and a variety of smaller public insurance programs.

Discretionary employer contributions to benefits in the Chamber of Commerce data represented 23 percent of wages and salaries in 1982. Of this amount, nearly two-thirds (60.4 percent) were fully taxable both by Social Security and by the individual income tax. The fully taxable benefits reported in the Chamber of Commerce data include employer payments for time not worked (paid vacations, holidays, and sick leave) as well as paid rest periods, lunch periods, and other paid employee time not directly spent in production. Less than one-third of the total level of employee benefits reported in the Chamber of Commerce data (27.7 percent) represent discretionary tax-favored benefits paid by employers. In 1982, tax-favored benefits totaled about 9 percent of wages and salaries.

The Size of Tax-Favored Employee Benefits—Employer contributions to tax-favored benefits—those that are not taxed as current income to the employee—can be divided into two groups: benefits on which taxes are *deferred* and benefits that are tax *exempt*.

- Tax-deferred benefits include primarily employer contributions to retirement income and capital accumulation plans. These constituted about 4 percent of wages and salaries in 1982. Taxation of these benefits is deferred until the employee withdraws funds from the plan.
- Tax-exempt benefits include employer contributions to group health insurance and a variety of smaller benefits that include dental insurance, child care, merchandise discounts, and employer-provided meals. These benefits constituted 4.6 percent of wages and salaries in 1982.[1]

Failure to distinguish among the growth of legally required employer

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[e]EBRI tabulation of Chamber of Commerce estimate of merchandise discounts, meals furnished by company, payments for vision care and prescription drugs, moving expenses, and contributions to employee thrift plans. Tax-preferred benefits are overstated by the amount of separation or termination pay received by employees but not distinguishable from other tax-favored benefits in the Chamber of Commerce estimates.

payments, fully taxable employee benefits, tax-deferred benefits, and tax-exempt benefits has greatly distorted the perception of the tax-base erosion that can be attributed to tax-favored and tax-exempt benefits. This common misperception was highlighted by Secretary of the Treasury Donald Regan; his May 22, 1983, statement to ABC News included the following comment:

> I think that when you look at the way our pension systems, our medical systems and the like are . . . running at full throttle, and are increasing year after year, that sooner or later they're going to have to be slowed down or else we'll never get these deficits under control.[2]

TABLE 2

Tax-Favored Employee Benefits by Specific Tax Treatment, 1982

Tax Status/ Benefit Group	Employer Contributions as a Percentage of Wages and Salaries	Employer Contributions as a Percentage of All Benefits	Employer Contributions as a Percentage of Tax-Favored Benefits
All Tax-Favored Benefits	9.0	27.7	100.0
Tax-Deferred Benefits:	4.5	13.8	49.5
Pension and profit-sharing plans[a]	4.0	12.3	44.0
Short and long-term disability insurance[a]	0.3	0.9	3.3
Other tax-deferred benefits[a]	0.2	0.6	2.2
Tax-Exempt Benefits:	4.6	14.2	50.5
Contributions to group health and life insurance[b]	4.1	12.6	45.1
Other tax-exempt benefits[c]	0.5	1.5	5.5

Source: EBRI tabulation of U.S. Chamber of Commerce estimates in *Employee Benefits 1982* (Washington, D.C.: U.S. Chamber of Commerce, 1983), pp. 11 and 28.

Note: Figures may not sum to totals due to rounding.

[a]EBRI estimate based on Chamber of Commerce figures.
[b]Estimate includes fully taxable employer payments for life insurance in excess of $50,000.
[c]EBRI estimate of discounts on merchandise, meals furnished by company, payments for vision care and prescription drugs, and moving expenses, based on Chamber of Commerce figures.

The size of tax-favored benefits as a proportion of wages and salaries, however, is much smaller than such statements suggest. Table 2 summarizes the distribution of tax-favored benefits by tax-deferred and tax-exempt status.

The Growth of Tax-Favored Employee Benefits—Over the past thirty years, tax-favored employee benefits have grown more rapidly than wages and salaries, and slightly faster than either legally required employer payments or fully taxable employee benefits. Consequently, tax-favored benefits have absorbed a rising share of total compensation. In the context of strong and increasing tax incentives for employees to demand a greater share of compensation in the form of tax-deferred or tax-exempt benefits, however, the growth of these benefits as a share of total compensation has been remarkably slow.

The National Income and Product Accounts data compiled by the Department of Commerce indicate that employer contributions to major tax-favored benefits as a fraction of total compensation increased at an average annual rate of 12.8 percent between 1960 and 1982. The long-term growth of tax-favored benefits relative to total compensation growth is presented in table 3. Although tax-favored employee benefits relative to total compensation grew rapidly between 1970 and 1975 (15.0 percent per year), it has slowed in more recent years (11.3 percent per year).

The growth in the early 1970s reflects several factors: (1) the slow growth of wages both before and during economic recession; (2) employer efforts to improve pension funding in anticipation of the enactment of the Employee Retirement Income Security Act (ERISA) and, in response to ERISA, net growth in pension and health plan participation; and (3) sudden increases in the employer cost of group health insurance benefits. The recent slower growth of employer pension contributions relative to total compensation may reflect employer adjustment to ERISA as well as employee demand for higher nominal wage compensation as real wage growth has slowed. The slower growth between 1980 and 1982 of employer health insurance contributions as a share of total compensation may reflect the maturation of group health coverage and benefits, as well as employer efforts to contain the cost of private health insurance plans.

Tax-Favored Employee Benefits: Goals, Achievements, and Effects—Employee benefits serve a number of purposes. Pensions, profit-sharing plans, and employee thrift plans provide for deferral of income and encourage private saving for retirement. Health benefits, disability income plans, life insurance, and supplemental unemployment benefits provide insurance protection against unanticipated, catastrophic events. Some programs provide for consumption; these include day-care benefits and, possibly, routine dental and vision care benefits. Many of these benefits,

TABLE 3

Employer Contributions as a Percentage of Total Compensation and Average Annual Growth Rates of Employer Contributions to Legally Required and Discretionary Benefits for Selected Years, 1960–1982

Year	Total Benefits[a]	Legally Required Benefits[b]	Discretionary Employee Benefits			
			Total	Pensions and Profit Sharing[c]	Group Health	Other Benefits[d]
Employer Contributions as a Percent of Total Compensation:						
1960	7.2%	3.1%	4.1%	2.5%	1.1%	0.4%
1965	8.1	3.3	4.8	2.9	1.5	0.4
1970	9.6	3.8	5.8	3.3	2.0	0.5
1975	12.5	4.9	7.7	4.5	2.6	0.5
1980	14.1	5.5	8.6	5.1	3.1	0.4
1981	14.6	5.8	8.8	5.1	3.2	0.5
1982	14.9	5.7	9.1	5.2	3.5	0.4
Average Annual Growth Rates of Employer Contributions:						
1960–1965	8.6%	7.3%	9.5%	8.6%	11.8%	8.1%
1965–1970	12.9	12.4	13.3	12.5	15.5	11.1
1970–1975	14.8	14.4	15.0	16.0	14.7	8.9
1975–1980	13.9	14.0	13.9	13.6	15.7	8.3
1980–1982	10.8	10.0	11.3	9.6	14.7	5.3
Summary of Average Annual Growth Rates:						
1960–1982	12.3%	11.8%	12.8%	12.4%	14.4%	8.8%

Source: EBRI tabulations based on U.S. Department of Commerce, National Income and Product Accounts data, various years.

[a]Figures may not sum to totals due to rounding.
[b]Legally required benefits include contributions to Old-Age, Survivors and Disability Insurance, Medicare, unemployment insurance and Workers' Compensation.
[c]Pension and profit-sharing plans include private and public contributions to federal, state and local civilian retirement plans.
[d]Other benefits include employer contributions to directors' fees, life insurance plans, supplemental unemployment and Workers' Compensation.

together with employee vacation time and rest periods, are intended to raise employee productivity, reduce time lost from work, and build positive employee relations.

Expanded employer pension and welfare plans over the past thirty years have significantly improved the income security of current workers and future retirees. Growth of employer group health insurance coverage

among workers and their dependents has promoted wide access to health care throughout the nonelderly population. These achievements are, in part, a response to tax incentives.

Pensions—Between 1950 and 1979, the rate of worker participation in employer pension plans grew by 23 percent; in absolute numbers, participation rose by 263 percent.[3] Although the passage of ERISA interrupted the sustained growth of pension participation rates, recent data suggest that the post-ERISA contraction of pension participation rates was a temporary phenomenon. Between 1977 and 1979, the proportion of the labor force that participated in private pension plans showed modest growth, despite accelerated growth in the size of the labor force during that period.

In 1979, more than 68 percent of private-sector, nonagricultural workers between the ages of twenty-five and sixty-four were covered by an employer pension plan.[4] At current rates of coverage, 73 percent of current workers aged twenty-five to twenty-nine can expect to receive a private pension when they retire.[5] Recent econometric studies indicate that approximately one-fourth of the increases in pension contributions as a proportion of total compensation over the past twenty years can be attributed to changes in real marginal tax rates.[6] Given the growing importance of the private pension system in providing retirement income security for most Americans, the tax deferral of pension contributions until retirement appears to be a reasonable, equitable, and effective incentive for private retirement saving. The reduction or elimination of this incentive would threaten the adequacy of private pension income for future retirees at the very time that Social Security will be least capable of expanding benefits.

The long-term revenue loss associated with the tax deferral of employer contributions to pensions, furthermore, may be negligible. The marginal tax rates affecting future retirees are likely to be significantly higher than those affecting current retirees. In addition, as the private pension system matures, the mix of workers and beneficiaries is beginning to change. This change alone reduces the level of tax expenditures as currently measured in the federal budget.[7]

Health Insurance—The 1980 Current Population Survey indicates that more than 60 percent of the civilian population was covered by an employer group health plan during 1979.[8] More than 74 percent of all workers and nearly 89 percent of full-time, full-year workers participated in an employer group health plan that year. Although it is clear that coverage rates have expanded rapidly over the past thirty years, the absence of time-series data on employer health coverage rates precludes the measurement of its relative importance in expanding employer contributions to health insurance.

Several factors have encouraged the expansion of employer group health insurance among workers and their dependents. Scale economies associated with greater inclusion of employees in the insurance group have encouraged the extension of health insurance coverage to lower-income workers. The growth of real marginal tax rates since 1960, moreover, has probably increased the demand for employer-provided health insurance. At the same time, the absorption of preferred risks into employer group plans has raised the cost of individually purchased health insurance relative to the before-tax value of employer group coverage.

All of these factors have served to raise the rate of health insurance coverage provided through employer group plans. In 1979, more than 83 percent of all persons with private health insurance were covered by an employer plan.

An Assessment of Retirement Program Tax Expenditures

Each year a set of "tax expenditure" estimates is developed by the Department of the Treasury and published as part of the federal budget. In 1974, the Congressional Budget Act (P.L. 93-344) formally institutionalized tax expenditures as part of the regular budget document. The law defined tax expenditures as "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[9] Tax expenditures are thus considered as "exceptions to the normal structure" of the tax code, and have been incorporated into the Congress' annual debate over tax options to reduce the federal deficit.

Private retirement program tax expenditures are the largest single category of tax expenditures in the 1985 budget. Private retirement tax expenditures arise from the deferral of taxes paid on pension and retirement saving contributions and earnings on these contributions. These deferrals are considered a current revenue loss; taxes are paid on withdrawals from the funds after retirement.

The magnitude of private retirement tax expenditure estimates has attracted the attention of many members of the Congress who are anxious to shrink federal budget deficits by closing tax "loopholes." Tax expenditure estimates are being used in this context as a guide to potential sources of new federal revenues. This section evaluates the use of federal tax expenditure estimates for private retirement programs as guides for: (1) tax policy; and (2) retirement policy at the federal level. In general, tax expenditures are probably a poor guide for legislating federal policy in either area.

The Estimation of Tax Expenditures—The estimation of tax expenditures, in the case of private retirement programs, is a two-step process. First, taxes that are deferred on employer pension contributions and personal individual retirement account (IRA) contributions, as well as the interest paid to these funds, are estimated.[10] From this estimate of deferred tax revenue, the Treasury subtracts estimated tax collections on pension benefits currently paid. The difference is the Treasury's estimate of tax expenditures resulting from the tax treatment of retirement programs.

This estimation procedure produces a "cross-sectional" estimate of tax expenditures. Deferred revenue estimates are based on one set of individuals (current workers), while offsetting tax collection estimates are based on an entirely different set of individuals (current retirees). The cross-sectional nature of these estimates presents major problems in using tax expenditures to guide either federal tax policy or federal retirement policy.

Tax Expenditures as a Guide for Tax Policy—To assess the usefulness of tax expenditure estimates as a guide for tax policy, it is first necessary to agree on the goals of federal tax policy. It is reasonable to assert that the primary goal of tax policy is securing a reliable flow of tax revenue commensurate with anticipated public expenditures. Tax expenditure estimates for private pension programs, however, may offer little guidance in meeting this goal.

One reason that tax expenditure estimates for private retirement programs are probably a poor guide for setting federal tax policy is that they measure only current revenue flows: current revenue deferrals minus current revenue receipts. Tax policy based on tax expenditure numbers, therefore, can be short-sighted if there is reason to expect significant change in tax expenditures in outlying years. This is the case with respect to tax expenditures for private pension programs.

There are two reasons for anticipating a decline in the level of tax expenditures associated with the tax deferral of private pension contributions and retirement savings. First, private pension participation and private retirement saving among current workers have grown substantially during the last two decades. This implies that future retirees are likely to have higher levels of retirement income—and pay taxes at higher marginal rates—than current retirees. As rates of private pension participation and retirement saving stabilize, the tax loss associated with current contributions and the tax revenues from current retirement income will become more equal, and the level of tax expenditures will fall.[11]

Second, both the population and the private pension system in the United States are relatively young. As the population ages and the pension

system continues to mature, the ratio of plan participants to beneficiaries will fall. Today's relatively small number of beneficiaries, and the relatively low taxable income of today's beneficiaries, result in current estimates of tax expenditures for private pension programs that are probably higher than future estimates will be. In terms of guiding federal tax policy, current tax expenditure estimates may overstate significantly the long-term federal revenue yield from revising the tax treatment of private pension programs.

Another reason that tax expenditure estimates may be a poor guide for tax policy is that they are computed "at the margin"—that is, each tax expenditure item is computed taking as given: (1) the revenue yield from current tax code provisions; and (2) all other tax expenditure items. As a result, the estimates do not reflect the interaction of any one tax expenditure item with the current tax base or with other tax expenditure items that the Congress may consider modifying. This means that tax expenditure estimates are not a true measure of the near-term, net revenue yield that might follow revision of the tax code affecting private pension programs or any other area.

Many "exceptions" in the tax code that affect the elderly population (the exemption of one half of income from Social Security and the double personal exemption allowed persons over age sixty-five, for example) are implicit in the tax expenditure numbers for private pension programs. Changes in these special provisions of the tax code—also considered tax expenditure items by the Treasury—would greatly affect the net revenue yield of a change in the present tax treatment of private pensions and retirement saving. In turn, the current taxation of pension contributions and retirement saving would reduce revenues from the taxation of Social Security income by lowering the marginal tax rates of retirees.

The tax expenditure estimates do not accurately measure the net revenue yield of changes in the tax code for another reason as well: they assume no change in the public's behavior in response to changing tax liability. These two aspects of the tax expenditure numbers—the fact that they ignore both the interactive effects of tax code change and taxpayer response to change—are strong arguments against relying on tax expenditures to guide even near-term federal tax policy.

Tax Expenditures as a Guide for Retirement Policy—To evaluate tax expenditure estimates as a guide for federal retirement policy, again it is necessary to consider policy goals. In the case of federal retirement policy, both a primary and ancillary goal can reasonably be asserted. These are, respectively: (1) to ensure adequate retirement income for the elderly; and (2) to encourage private provision for retirement, reducing reliance on the public sector for retirement income. Tax expenditure estimates for

private retirement programs, however, are probably a poor guide for evaluating or altering retirement policy simply because they bear no relationship to retirement policy goals.

Tax expenditure estimates are irrelevant to the goals of retirement policy largely because they are cross-section estimates, not lifetime estimates. Since they cannot be related to any individual or cohort of individuals, they do not reflect federal tax policy toward private pensions or retirement saving in any definable way. Even if the estimation of tax expenditures were refined to reflect lifetime tax expenditures, however, the issue of how they relate to the adequacy of private retirement provisions would remain. While this issue is not irresolvable, tax expenditures as they are currently estimated cannot be used to address questions about tax incentives for individuals to provide for adequate retirement income.

Tax expenditure estimates, moreover, can be misleading if they are used to compare federal tax policy toward private and public retirement plans. Estimated tax expenditures for private retirement programs are much higher than estimated tax expenditures for participants in the civil service or military retirement systems. This does not reflect preferential tax treatment for private retirement programs or greater incentives for private retirement program participation. It simply reflects the different funding standards under which private and public pension plans operate (as well as the fact that public plans are more mature—that is, they have a higher ratio of beneficiaries to current participants).

ERISA established minimum funding standards for private pension plans. The more rapid funding of private pension obligations in compliance with ERISA has contributed to the emergence of greater tax expenditures for private pension plans than for public pension plans. ERISA does not apply to either the civil service retirement plan or to the military retirement plan. The civil service plan, as a result, is largely financed on a pay-as-you-go basis. The military retirement plan is totally unfunded; no contributions or interest are paid to a trust fund, since no fund exists.

The difference between private and public funding standards affects the interpretation of tax expenditure estimates. The discrepancy between tax expenditures for private and public plans reflects the slower funding of public retirement plans allowed by law and, consequently, the lower current cost of public plans. If the civil service and military retirement plans had met their normal cost contribution plus the forty-year annual amortization schedule stipulated in ERISA as the minimum funding requirement for private plans established before 1974, employer contributions to these two plans would have totaled $89 billion in fiscal 1981.[12] This is nearly 49 percent more than total employer contributions to all private plans in 1981. In fact, the Treasury considers only one-fifth ($18.2 billion) of the

federal contribution that would be required were the civil service and military retirement plans subject to the same funding standards as private plans.

The impact of funding on tax expenditure numbers is also an important factor in interpreting changes in tax expenditures for private retirement programs from year to year. Slower funding of private pension plans within the bounds set by ERISA would result in lower current costs for pension plans and lower estimates of tax expenditures. Slower funding of private plans, however, is probably undesirable from the viewpoint of federal retirement policy.

The Use of Tax Expenditures—The discussion above raises a question about whether tax expenditure numbers can be validly used in any policy context. The appropriate uses of these numbers are limited; the presentation of tax expenditures in the annual budget, moreover, tempts many to misuse them.

Tax expenditures as they are now estimated are simply estimates of deferred revenue flows; as such, they illustrate the current cost of exceptions to the federal income tax structure. They do not, however, measure the net revenue yield that might result from eliminating a particular "exception" to the tax structure. Nor can they provide an assessment of whether revision of the tax code is desirable in any other policy context.

Proposals to Reform Tax Preferences for Health Insurance

The expansion of health insurance benefits offered by employer group plans and employers' past willingness to absorb inflation in health care costs have become controversial issues in the debate to reform the tax treatment of health insurance. Critics of current tax policy contend that the "generosity" of employer group coverage and the insensitivity of employer plan benefits to rising costs have encouraged continued inflation in health care costs. Proposals that would modify the tax exemption for health insurance expenditures are of two types: those that would place a ceiling on the exemption of employer health insurance contributions in order to discourage generous coverage under employer group plans, and those that would eliminate all tax preferences for employer health insurance contributions within the framework of comprehensive tax reform. The first type, those that "cap" the exemption of employer contributions, would impute all employer health insurance contributions in excess of a specified cap as employee earnings. Contributions above the cap would be taxable by both the individual income tax and Social Security. The Reagan Administration proposal, as introduced in Senate bill S. 640, would vary the amount of the cap for individual versus family coverage, and would be

adjusted annually by the consumer price index. Proposals of the second type, those that eliminate all federal tax preferences for employer health insurance contributions, include the Bradley-Gephardt comprehensive tax reform bill (S. 1421/H.R. 3271). This bill would require all employer health insurance contributions to be imputed as employee earnings, and at the same time the bill would raise the individual income tax floor for deducting health insurance expenditures to 10 percent of adjusted gross income.

The difference between proposals that would modify tax preferences for employer health insurance contributions and those that would eliminate them altogether is probably in the magnitude of effects rather than in the nature of effects. The effects of these proposals fall into four categories: (1) changes in the generosity of coverage provided by employer group plans; (2) changes in employer costs; (3) changes in the rate of health insurance coverage among workers and their dependents; and (4) changes in tax revenues and the distribution of the tax burden. Each of these effects is discussed in turn.

Impact on the Generosity of Health Insurance Coverage—The most commonly used argument for reducing or eliminating tax preferences for employer contributions to health insurance is the potential effect on the scope and completeness of coverage offered by employer group plans. Advocates of reduced tax preferences point to the relatively abundant literature on the relationship between greater cost sharing and lower health care costs as evidence that tax-exempt employer contributions encourage coverage with little cost sharing and, consequently, greater use of health care services. Removal of tax exemptions, they argue, will encourage less comprehensive coverage and lower use of services. Reduced use of health care services will, in turn, cut aggregate health care costs and ultimately dampen inflation in health care prices.

People who support continued tax preferences for employer health insurance contributions claim that the foregoing argument ignores the complexity of consumer demand for health insurance in an interdependent, multiproduct market. They argue that rational consumers are unlikely to reduce coverage for the particular service category—hospital care—that drives health care cost inflation. Other service categories—coverage of primary physician care, preventive services, and routine dental and vision care—are more vulnerable than hospital coverage to tax policy that would increase the price of health insurance to consumers. The cost of these services, however, has been remarkably stable relative to the cost of hospital care. These people conclude that tax policy, if at all successful, is likely to be an inefficient way to contain further inflation in health care costs.

These opposing views have not been satisfactorily resolved; neither position is based on a substantial body of research. If the deadlock is to be broken, other arguments that might support the revision of tax preferences for employer health insurance contributions must be considered. These include the impact of taxation on employer costs, on the rate of health insurance coverage among worker households, and on federal revenues and the tax burden.

Impact on Employer Costs—Taxation of employer contributions to health insurance raises the cost of coverage to participants in employer group health plans. Low (that is, stringent) tax caps on employer contributions create an incentive for low-risk employees to reduce their after-tax health cost by seeking less complete or less comprehensive health insurance coverage. The exit of low-risk participants from existing plans (that is,"adverse selection") raises the average risk that people who remain in the plan represent. As a result, the average cost of the plan rises.

Employers have objected to the proposed taxation of contributions to health insurance because they expect taxation to significantly raise their costs of providing health insurance benefits. Increased employer costs might result in several ways. First, employer tax liability under Social Security would rise. Since employer payments to Social Security are deductible under the corporate income tax, however, the net increase in employer tax liability is likely to be modest.

Second, employers expect that workers will respond to taxation of health insurance contributions by demanding higher cash wages or more tax-exempt benefits in an effort to maintain before-tax compensation levels. The adverse selection of low-risk employees from existing plans, moreover, may generate a second-round increase in employee demand for greater before-tax compensation. As low-risk plan participants leave the "standard" plan, the average cost of the plan—and employer contributions for the remaining participants—will rise. Employers will probably experience substantial pressure from employees who benefit from generous plan coverage to continue to offer that coverage. At the same time, equivalent compensation for employees who leave generous plans would rise as the average cost of standard coverage increases.

Finally, because of pressure from some employees to offer less expensive alternative health insurance coverage, employers foresee increased administrative costs as well as the loss of some scale economies in their group plan benefits. The fragmenting of existing employer group plans into a number of smaller plans may increase insurance costs for smaller employers or reduce the coverage that employers are able to provide at current outlays.

Impact on the Rate of Health Insurance Coverage—If employer and employee costs for health insurance rise, some employees may forego health insurance coverage altogether. An EBRI simulation of the rates of health insurance coverage that might emerge among the currently insured population in the absence of an employer contribution produced some dramatic results. Fewer than half of all persons living in worker families with annual incomes less than $15,000 (in 1979) would have had private health insurance coverage in the absence of any employer contribution (see table 4). In addition, periods of unemployment appear to have a significant impact on insurance coverage. Even moderate periods of unemployment (four weeks or less) appear to generate very long lapses in health insurance coverage among workers and their dependents when reemployment does not provide an employer contribution to health insurance.

These simulations cannot provide precise estimates of the changes in health insurance coverage among the population that might ensue if employer contributions to health insurance were taxed either in whole or in part. They do indicate, however, the function served by current tax preferences for employer health insurance contributions. Current tax policy probably raises private coverage rates significantly among families of lower-income workers, families of workers with fragmented employment histories, and younger families, as well as among single persons and single-parent families. In addition, current tax policy toward private health insurance probably reduces significantly both Medicare and Medicaid costs.

Impact on Tax Revenues and Tax Burden—Using a simulation of federal tax liability among households sampled in the 1977 National Medical Care Expenditure Survey, CBO has estimated that substantial new federal revenues might result from various "caps" placed on the tax exemption of employer contributions to health insurance.[13] For example, CBO estimates that new federal revenues of $4.6 billion might result from a low (that is, stringent) cap of $1,440 annually for family coverage and $576 for individual coverage effective in 1983. Based on assumptions of static coverage and continued growth in employer plan costs, CBO's projected estimates of potential federal revenues between 1983 and 1987 rise at an average annual rate of more than 30 percent.

But the estimates, themselves, are fragile. They are: (1) susceptible to the assumptions on which they are based; and (2) sensitive to small differences in the exclusion limit proposed.

The primary assumptions include: (1) the cost of health insurance coverage; (2) the rate of employer contributions as a percent of cost; and

TABLE 4

Actual and Simulated Probability of Private Health Insurance among Workers and Members of Worker Families by Selected Characteristics, 1979 (Percents)

Family Characteristic	Probability of Private Health Insurance Coverage					
	Workers			Members of Worker Families		
	Actual	Simulated	Change	Actual	Simulated	Change
All Persons[a]	96.7	77.8	−18.9	93.1	84.1	−9.0
Family Income:						
$ 0–7,499	97.5	11.1	−86.4	82.9	11.0	−71.9
7,500–14,999	95.9	40.2	−55.7	89.7	55.3	−34.4
15,000–19,999	97.4	74.4	−23.0	93.7	91.1	−2.6
20,000 or more	96.7	87.5	−9.2	94.4	92.4	−2.0
Age of Primary Earner:						
Less than 18	91.2	69.4	−21.8	66.4	23.5	42.9
18–21	91.0	64.0	−27.0	86.9	47.4	−39.5
22–35	97.4	70.3	−27.1	94.3	77.9	−16.4
36–64	98.9	90.7	−8.2	93.1	92.4	−0.7
65 and over	91.1	61.1	−30.0	90.5	75.4	−15.1
Unemployment of Primary Earner:						
None	97.3	81.0	−16.3	93.3	87.1	−6.2
1–4 weeks	94.3	66.7	−27.6	92.9	65.3	−27.6
5–12 weeks	91.7	63.9	−27.8	90.5	63.9	−26.6
13 weeks or more	93.2	41.1	−52.1	89.8	32.1	−57.7
Spouse Present:						
Yes	97.3	90.2	−7.1	95.4	92.3	−3.1
No	95.0	42.2	−52.8	84.8	53.3	−31.5
Children Present:						
Yes	97.2	82.2	−15.0	94.1	85.3	−8.8
No	96.3	73.2	−23.1	91.5	81.8	−9.7
Medicaid/Medicare Eligible:						
Yes	90.4	38.1	−52.3	70.9	44.2	−26.7
No	97.1	79.9	−17.2	94.9	87.2	−7.7

Source: EBRI simulation of private health insurance coverage with full taxation of employer contributions to health insurance.

Note: Actual and simulated rates among workers and members of their families that *reported* an employer contribution to coverage of any family member in 1979.

[a]Includes some persons with incomes less than zero in 1979.

(3) the rate and distribution of health insurance coverage among worker households. The cost factor currently used by the U.S. Treasury for projecting health insurance premiums is an actuarial estimate that rises somewhat faster than the projected growth in the medical care component of the consumer price index. Both the rate of employer contributions and the rate of health insurance coverage are assumed to rise slowly (less than 1 percent annually) after the tax exclusion is reduced.[14]

Use of these assumptions probably introduces substantial error into the calculation of potential revenues. Virtually any other assumptions, however, would be equally hypothetical. The cost of private health insurance, for example, relies on the package of health insurance benefits offered by employers, reimbursement arrangements made with providers, and the shortfall of Medicare and Medicaid reimbursement relative to provider costs. All these factors are undergoing dramatic change. Researchers have not developed a method for accurately predicting the effects of these changes on employers' insurance costs. But, clearly, these changes will affect the ultimate yield of a tax on employers' contributions to health insurance. Furthermore, although it might be argued that taxation of employer contributions would raise employer contributions as a share of plan costs, surveys suggest that, everything else being equal, employers are generally reducing their health insurance contributions as a share of plan costs. In any case, the future rate of increase in employer contributions as a share of plan cost cannot be calculated with precision, given the revision of tax incentives.

CBO's revenue projections also indicate a high degree of sensitivity to modest adjustments in the proposed cap (see table 5). This sensitivity reflects the relatively narrow dollar range of employer contributions to health insurance and the weak relationship between the size of employer health insurance contributions and household income. Among all employer group health plan participants included in the National Medical Care Expenditures Survey, three-quarters of those with an employer contribution to individual coverage received a contribution between $100 and $500 in 1977. More than half of all plan participants with an employer contribution to family coverage received a contribution between $500 and $1,200 in 1977.[15] Because of the relatively narrow range of these contributions, modest adjustments to the level of a proposed cap can affect a significant proportion of all persons who receive an employer contribution to coverage.

The distribution of the tax burden that would result from limiting the tax exclusion of employer contributions to health insurance reflects the flat distribution of employer contributions to health insurance over most levels of family income. Relatively constant employer contributions at all

TABLE 5

Sensitivity of Projected Federal Revenues to Selected Tax Exemption Limits on Employer Contributions to Health Insurance, 1983

Proposed Limit Family/Individual Coverage (Monthly)	Projected Federal Revenue[a] (Billions)	Increase in Limit (Percent)	Decrease in Projected Revenue (Percent)
$120/$48	$4.6	—	—
135/ 54	3.7	12.5	19.6
150/ 60	2.9	11.1	21.6
165/ 66	2.3	10.0	20.7
180/ 72[b]	1.8	9.1	21.7

Source: U.S. Congress, Congressional Budget Office, *Containing Medical Care Costs Through Market Forces* (Washington, D.C.: Government Printing Office, May 1982), p. 35.

[a]Includes revenues from both individual income and Social Security taxation of simulated employer contributions above the exclusion limit in 1983. Social Security tax revenues represent about one-quarter of total projected tax revenues. Estimates assume full application of the exemption limit to collectively bargained and nonunion plans.

[b]Limits proposed in S.640 (98th Congress) are set at $175/$70 for family/individual coverage, effective January 1, 1984. This legislation would "grandfather" collectively bargained plans. Projected 1984 revenue, assuming application of the exemption limit to only about one-quarter of collectively bargained plans in 1984, is $2.4 billion (U.S. Department of the Treasury, unpublished estimate).

income levels obviously represent a larger percentage addition to family income at lower levels of income than at higher levels of income. Limiting the tax exclusion of employer contributions to health insurance, therefore, tends to place a relatively heavy tax burden on families at lower income levels. In general, the federal income tax structure is not sufficiently progressive to offset both the distribution of employer contributions and the regressivity of the Social Security tax on earnings.

CBO has estimated the tax burden that would result from capping the tax exclusion of employer contributions to health insurance (see table 6). Among households affected by a cap of the tax exclusion of employer contributions to health insurance, the tax burden would be severely regressive. Persons at the lowest levels of income (those reporting less than $10,000) would pay (as a percentage of income) more than six times the amount of additional tax that persons with incomes over $50,000 would pay. The regressive impact of taxing employer contributions to health insurance is a major argument against proposals to limit the tax exclusion of contributions at all but the highest level. The argument in favor of a high

TABLE 6
Distribution of Additional Annual Tax Burden of $1,800 Annual Exemption Limit in 1983 by Household Income

Annual Household Income[a]	All Households: Average Additional Taxes[b]	All Households: Percent of Income	Households Affected: Percent Affected by Limit	Households Affected: Average Additional Taxes	Households Affected: Percent of Income[c]
$ 0– 10,000	$ 3	0.05	2	$138	2.76
10,001– 15,000	14	0.11	9	168	1.34
15,001– 20,000	21	0.12	14	147	0.84
20,001– 30,000	44	0.18	23	191	0.76
30,001– 50,000	88	0.22	33	267	0.68
50,001–100,000	116	0.18	36	323	0.43
Over 100,000	108	0.08	27	403	0.40

Source: U.S. Congress, Congressional Budget Office, *Containing Medical Care Costs Through Market Forces* (Washington, D.C.: Government Printing Office, May 1982), p. 36.

[a]Household income before taxes, but including cash transfer payments (e.g., Social Security benefits) projected to 1983.
[b]Includes both federal income tax and the employer's and employee's share of federal payroll taxes. About three-quarters of the tax burden results from federal income tax liability. State and local income taxes are excluded. Estimates assume that taxable excess contributions are ineligible for the medical expense deduction under the federal income tax.
[c]Calculated by EBRI at the midpoint of the income range.

tax exclusion limit, however, is weak; a high cap would affect only a small proportion of all households and yield very little additional federal revenue.

The Effectiveness of Tax Policy in Containing Health Care Costs—Federal tax policy has not discouraged the emergence of generous employer-provided health insurance plans. But empirical studies suggest that tax policy has contributed only slightly to the development and growth of these plans. Generous coverage for in-hospital care under employer plans emerged for many reasons; possibly the most important is the historical precedent established by hospital- and physician-owned Blue Cross/Blue Shield plans in the 1930s. Generous health insurance coverage has also been encouraged by labor unions as an important part of wage bargaining.

The most important source of expanding coverage and rising health service demand over the past two decades, however, has been the public sector. Since 1967, the public sector has purchased more than a third of all personal health care and more than half of all hospital care. Most of the

growth of public spending for personal health care is attributable to the growth in Medicare and Medicaid spending. In 1981, these programs purchased more than one third of all hospital care delivered in the United States. Since 1965, the proportion of all hospital care purchased with private insurance has fallen steadily (see table 7).

The size of public spending relative to privately insured spending for personal health care is important in considering a revision of federal tax policy toward private health insurance. In legislating the Medicare and Medicaid programs, Congress established a standard of access to comprehensive health insurance coverage across the population. Federal tax policy that would significantly reduce private health insurance coverage—or jeopardize access to coverage among middle- and low-income persons—would promote gross inequities between the general population and persons eligible for coverage through the public sector. Federal policy that would reduce eligibility or coverage under Medicare or Medicaid, moreover, is reasonable only if persons who lose public-program benefits are likely to obtain health insurance coverage in the private sector. It is difficult to reconcile reductions in both public-program benefits and private-sector incentives for health insurance coverage. Furthermore, as

TABLE 7
Percentage Distribution of Expenditures for Hospital Care by Source of Payment for Selected Years, 1965–1982

	Private				Public		
Year	Total[a]	Patient Direct Payments	Health Insurance	Other	Total[a]	Medicare and Medicaid	Other
1965	61.2	17.2	41.8	2.2	38.9	—	38.9
1970	47.2	10.0	35.8	1.4	52.9	26.3	26.6
1975	44.7	8.2	35.4	1.1	55.3	31.3	24.0
1978	45.6	8.6	35.8	1.2	54.5	33.6	20.9
1979	46.2	9.9	35.0	1.3	53.8	33.9	19.9
1980	45.9	10.0	33.5	1.5	54.1	35.5	18.8
1981	45.7	10.8	33.4	1.5	54.3	35.5	18.6
1982	46.9	12.1	33.2	1.6	53.1	35.6	17.6

Sources: R.M. Gibson, D.R. Waldo, and K.R. Levit, "National Health Expenditures, 1982," *Health Care Financing Review*, vol. 5, no. 1 (Fall 1983), pp. 7 and 12; R.M. Gibson and D.R. Waldo, "National Health Expenditures, 1980," *Health Care Financing Review*, vol. 3, no. 1 (September 1981), pp. 44–47.

[a]Figures may not sum to totals because of rounding.

long as public spending for Medicare and Medicaid continues to rise, inflation in aggregate health care costs will persist. Federal tax policy that attempts to dampen private-sector demand for health care will probably have little independent effect on health care cost inflation.

Notes

1. EBRI tabulations of estimates produced by the U.S. Chamber of Commerce, *Employee Benefits 1982* (Washington, D.C.: U.S. Chamber of Commerce, 1983), pp. 11 and 28. These figures are generally corroborated by the National Income and Products Account data published by the U.S. Department of Commerce.
2. "This Week With David Brinkley," Show no. 82, transcript (May 22, 1983) produced by Journal Graphics, Inc., New York, N.Y., p. 8.
3. S.J. Schieber and P.M. George, *Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement* (Washington, D.C.: Employee Benefit Research Institute, 1981), pp. 54-55.
4. Ibid., p. 41.
5. "Background Analysis of the Potential Effects of a Minimum Universal Pension System," developed by ICF, Inc., for the President's Commission on Pension Policy and the Office of Pension and Welfare Benefit Programs, Washington, D.C., 1981, p. 38.
6. Sophie M. Korczyk, *The Federal Tax Treatment of Pensions and Deferred Compensation Programs: Background, Issues, and Options* (Washington, D.C.: Employee Benefit Research Institute, forthcoming).
7. Employee Benefit Research Institute, "Retirement Program Tax Expenditures," EBRI *Issue Brief*, no. 17 (April 1983), p. 4.
8. This section summarizes material presented in: Deborah J. Chollet, *Employer-Provided Health Benefits: Coverage, Provisions and Policy Issues* (Washington, D.C.: Employee Benefit Research Institute, 1984).
9. *Special Analyses, Budget of the United States Government, Fiscal Year 1981* (Washington, D.C.: Office of Management and Budget, 1980), p. 207.
10. The Treasury also considers personal contributions and interest paid to Keogh plans in computing deferred tax collections. The amount of funds paid into Keoghs, however, is much less than the amount of funds paid into IRAs; consequently, Keoghs are a relatively minor component of estimated federal revenue "loss."
11. Several *ceteris paribus* assumptions underlie any statement of this type. These include assumptions about future levels of real income and prices, as well as assumptions about the structure of the individual income tax in future years.
12. Based on actuarial reports on the civil service retirement system and military retirement system filed with the U.S. Congress in compliance with Public Law 95-595 for fiscal 1981, as presented in: Employee Benefits Research Institute, "Retirement Program Tax Expenditures," EBRI *Issue Brief*, no. 17 (April 1983).
13. U.S. Congress, Congressional Budget Office, *Containing Medical Care Costs Through Market Forces*, (Washington, D.C.: Government Printing Office, May 1982).
14. The assumed monthly exemption limit is $175 for family coverage and $70 for individual coverage, effective January 1, 1984. The projected growth of employer contributions and worker coverage is based on actuarial estimates.
15. Gail R. Wilensky and Amy K. Taylor, "Tax Expenditures and Health Insurance: Limiting Employer-Paid Premiums," *Public Health Reports*, July/August, 1982, table 2.

Trends Resulting from the Current Tax Treatment of Employee Benefits

Everett T. Allen, Jr.

For years, the tax policy in this country has been relatively straightforward. We all know what it is: employers' contributions to employee benefit plans have been tax favored. In most cases, this means that investment income on assets could accumulate with taxes deferred until distribution of benefits, and benefit distributions have been accorded very favorable tax treatment. As a result, many employers have had clear incentives to establish programs. But, in recent years, a number of changes have occurred.

Inconsistencies in Tax Policy

First, our tax policy has become increasingly complex and its application, sometimes inconsistent. For example, the Employee Retirement Income Security Act of 1974 (ERISA) does not require employers to establish retirement plans, but if you do establish a plan, it is clear that you must disclose the plan's provisions, observe minimum participation standards, observe benefit accrual and vesting rules, and—this is very important—fund the benefits on a significant minimum basis.

Some limitations to section 415 of the Internal Revenue Code have recently been enacted. The legislation is quite clear that employers cannot fund in anticipation of increases in the section 415 limits stemming from changes in the consumer price index, even though the increases will occur automatically. The practical effect has been to weaken the funding of many plans, and many employees will be affected. I believe this situation is totally inconsistent with one of the basic benefit security objectives of ERISA.

Another area of inconsistency has recently emerged. When we consider policy in the area of retirement programs and employee benefits in general, we have to look beyond the tax law. Thus we must look at the impact of the 1983 Social Security Amendments. We have had, in effect, a fundamental change in national policy concerning appropriate retirement ages—one that is totally inconsistent with the practice that has existed in private plans.

Almost all the plans I work with subsidize and encourage early retirement. Social Security, with delayed retirement credits and the change in

retirement age, is now going in exactly the opposite direction. I believe many employees will have serious difficulty coping with this change.

We need to reconcile the divergent policies. At the moment, ERISA prohibits plans from adjusting their normal retirement age beyond sixty-five, but I am sure that will be corrected.

Administrative Burdens

You are certainly familiar with the imposition of burdensome and questionable administrative procedures in the area of private plans. I still remember that it took the Department of Labor 42,000 words to define a year of service. I thought I had a reasonably good handle on that before 1974.

There have been many problems with recordkeeping, disclosure requirements, financial reporting and the like. Many people question what has been achieved through all this effort.

Emphasis on Defined Contribution Plans

One of the most important policy changes, whether it has been consciously designed or not, is the increasing emphasis in recent years on defined contribution plans vis-à-vis defined benefit plans, as evidenced in a host of legislation: individual retirement accounts (IRAs), simplified employee pensions (SEPs), section 401(k) legislation, section 125 plans, employee stock ownership plans (ESOPs), Tax Reduction Act stock ownership plans (TRASOPs), special interest ESOPs—we could go on and on. But obviously, one of the most important influences has been the plan termination liabilities imposed by ERISA.

More recently substantial restrictions applicable to all plans have been imposed to prevent abusive discrimination in some plans, and these restrictions are causing a great deal of trouble. The most recently enacted changes in the Tax Equity and Fiscal Responsibility Act (TEFRA), including the reduction in the section 415 limits and the possibility of further reductions and rollbacks in that area, should cause many employers much concern.

These developments have dampened enthusiasm for the formation of defined benefit plans, and, concurrently, spurred growth in defined contribution plans. I am concerned that sometimes our planners seem to set our policies without thinking far enough ahead about the implications. In addition, defined contribution plans shift the investment risks to employees. It is possible to lessen the risks by requiring that assets be invested in relatively secure investments, such as guaranteed-interest arrangements.

But we still must be concerned about the effects that a continuing shift toward defined contribution plans will have on the money markets. Much money may be directed toward fixed-income securities and away from the equity market. I do not want to take a position on whether that would be good or bad, but people should consider the implications.

I am also concerned because defined contribution plans tend to emphasize lump-sum payments, and during accumulation periods, these plans may permit withdrawals of funds to purchase homes, finance vacations, finance college educations, and the like. We need to think about how this practice can erode retirement security.

It seems likely that more small-employer plans will be terminated. There has already been ample testimony to this possibility, and now there is evidence that, in reaction to TEFRA, many small employers may simply drop the qualified approach to providing retirement benefits.

Limitations on Contributions and Benefits

Section 415 limitations can have the same effect. This is a wild example, but the arithmetic is easy. If an executive earns $1 million a year, TEFRA allows that executive to have a 9 percent pension. It is quite possible that the executive will scale down his commitment to other employees so they will get a 9 percent pension as well. This example obviously stretches things, but it illustrates the point. Many smaller organizations, in particular, may find alternative forms of compensation, including simple cash, to be a more effective means of producing benefits for employees.

Employers have already demonstrated reluctance to modify plans or improve plans to adopt new programs in light of uncertainty. We hardly have time to get used to new legislation before another piece comes upon us, and we are not sure how to react. The delay in promulgating regulations does not help. In 1978 the "cafeteria" compensation legislation was enacted, but in 1983 there are still no regulations—they are not even on the regulatory timetable. People are very concerned about what they can and cannot do in this kind of environment.

I believe we are also going to see an increase in the growth of supplemental, nonqualified forms of compensation, such as deferred compensation, because of restrictions being imposed in the qualified area.

Summary

Some additional thoughts on national policy: it may sound like supporting motherhood, but I believe that national policy should nurture the private employee benefit system. These plans provide a network of eco-

nomic security, not only in the event of retirement, but in the event of death or illness. They also are of material value in the area of capital formation. Changes in policy can have far-reaching implications and policymakers need to recognize that for every action, there will be some reaction. I have already mentioned some examples. In any event, it is extremely important that these implications be thoroughly evaluated before changes are made.

Formulators of national policy also should recognize that private employee benefits are part of total compensation, and that changes in the national tax policy significantly affect the ability of employers to manage their enterprises.

Our policymakers also recognize that Social Security and private plans are the two major sources of income for people in retirement. If the results are to be equitable, the ability to integrate private plans with Social Security must be retained by Congress. For example, under the recent Social Security Amendments, Social Security benefits for middle- to upper-income retirees will be taxed. This taxation will reduce the effectiveness of the benefits. Although $25,000 a year for a single person and $32,000 for a married couple may sound like high figures, those figures are not indexed; in a short time many people will be affected, and the value of Social Security will drop.

In any event, Social Security provides very substantial benefits for low-income people. The present value of death benefits can be as much as eight or ten times the pay of the worker, depending on the method of calculation. Replacement ratios on an after-tax basis for married couples can reach 80, 85, even 90 percent of preretirement take-home pay. If organizations are unable to integrate plans to achieve appropriate benefits at all levels of pay, the effect on private programs will be very negative.

Short-term gains and reform really should not dictate our national policy. Proposals such as the taxation of income on plan assets will erode the overall value of the programs and the after-tax assets available to provide benefits. In the long term, the workers would suffer.

In closing, I want to emphasize that national policy is not limited to the tax law. We must also consider things like age and sex discrimination and changes in Social Security, because they operate as an integrated whole.

Discussion

MR. MELTON: I have three questions. The first relates to the minimum standards—the hour of service and the credited-service definitions. Although the regulations are comprised of some 42,000 words, they seem to be a thoughtful response to a difficult set of statutory rules that reflect a series of compromises between almost a paternal protection of employees and the plan. If these plans are terminated, certainly the doctors would lose some tax-favored retirement benefits, but how much would their employees really lose?

The second and third questions relate to Social Security and integration. If Social Security is sufficient as retirement income replacement, why do we need qualified plans in the first place? If Social Security handles postretirement needs, why do we have section 401(k)? On the other hand, if Social Security is not sufficient, why do we allow integration at all?

Revision of Regulations and Threatened Termination of Plans

MR. ALLEN: With respect to revising the regulations, I suggest a return to the notion that a year of service is a year of service. The Department of Labor, however, has issued regulations that, in my view, violate the law and say that "elapsed time" can be used. You start work one day, and you quit work on another: the period between the two is counted as employment. That, to me, is a very simple, direct solution.

As for who will be affected by threatened termination of plans, many plans provide significant benefits for many people. But we know there are abuses in the system, and the abuses ought to be corrected. But I have great difficulty in requiring a large company like General Motors to add the TEFRA top-heavy provisions designed for small pension plans, and then announce in its summary plan descriptions to employees that if the plan goes top heavy, the employees will be immediately vested, when in fact the General Motors plan will never be top heavy. This will confuse employees, not help them.

The policy we have designed and worked with does not take into account the fact that different employers have different objectives. I do not work for General Motors, but I can assure you General Motors does not design its programs to discriminate against some of its workers. If a corporation does do this, we can deal with the issue as it arises without subjecting all plans to the same restrictions.

The Role of Social Security and Income Replacement Rates

The third question asked was why do we need section 401(k) if Social Security provides so well for people. Social Security does provide very well for low-income people, but its benefits drop off sharply as income increases. The plans I work with are designed to achieve a combined income replacement ratio that, in fact, decreases as salary increases.

We might start with a program in which we try to generate 80 to 85 percent of total income replacement for low-income people, and scale that down to 45 or 50 percent for higher-income people. Social Security is providing total values that are reasonable, equitable, and nondiscriminatory, but not sufficient at all income levels.

MR. MELTON: If the tax system provides a subsidy, why do we need an 85 percent income replacement ratio? Why, in fact, should the tax system encourage any income replacement above some minimum level? In other words, is Social Security sufficient at that minimum level for low-income people?

MR. ALLEN: The only employer I know that has an 80 percent replacement ratio—or tries to—for all career employees at all levels is the federal government. The companies I work for do not try to achieve that kind of constant replacement ratio. They consciously design plans that decrease the replacement ratio as pay goes up. That is, in fact, the way the real world operates. Why should we have benefits above a minimum level? One reason we may want to do it is to encourage organizations to adopt programs. To return to my crude example of the executive who makes $1 million a year and is allowed to have a 9 percent pension—if a 9 percent pension is all he is allowed to have relative to his worth, income level, and value to the corporation, presumably if we have a constant replacement ratio concept, we drop everybody else back to 9 percent. I do not believe that result is the one we seek to achieve from the standpoint of social objectives.

Changing Family Models and Abuses in the Benefits System

MR. HALPERIN: I want to raise two points. One relates to the discussion about the replacement rate of Social Security. You referred to the amount of Social Security that would be received by a married couple with, I assume, one working spouse. It occurs to me that that kind of family relationship seems to be assumed in many of the examples of the adequacy of Social Security alone (and, therefore, the justification of integration). I wonder if the assumption is still accurate today, and if it is, how accurate it will be ten or fifteen years from now as a model for policy.

The second point relates to the abuses of the system. The assumption seems to be that the legislation that attempts to reduce the abuses has been misdirected or perhaps that no legislation could adequately attack the abuses without doing more harm than good.

I believe the companies that are using the private pension system for proper goals—or at least for goals that are consistent with public policy—would not oppose any legislation aimed at curbing abuse, but would support protection of the system against abuse and cooperate in working out legislation to curb abuse without harming the system as a whole. If it still proved impossible to solve the problem, then one might say, "We have to tolerate some abuse in order to get the system we need."

In today's world, that does not happen. Any effort at reform is attacked from all sides, even by those people who presumably would not be bothered by the goal of the reform but are troubled by its possible unintended side effects. Instead of trying to get rid of the possible side effects, these people end up on the opposing side; as a result, sensible legislation becomes an elusive goal. I just wonder why the benefits community cannot understand that the results might be better if they changed sides on these issues.

MR. ALLEN: I agree that the example of the married couple with one worker is being phased out of our economy as the number of women in the work force increases. The point I was making, though, remains valid. Social Security, even if you change that factor, still provides a higher replacement rate on an after-tax basis for lower-income people than for higher-income people. The aim of benefit integration is to try to level out the replacement rate differential and to provide some degree of income replacement from both sources that creates a fair and reasonable benefit for all.

MR. HALPERIN: One argument seems to be that the purpose of the private plan is to level out the differential in income replacement, while a second argument is that the purpose of the private plan is to bring retirement income up to adequacy for low- and moderate-income people. If you can make the case that Social Security provides 80 percent income replacement for low- and moderate-income people, the two positions are the same. Some people suggest that there is no need for the private plan at low- and moderate-income levels.

I have trouble with the argument that because Social Security provides 50 to 60 percent income replacement, let's say, for the people at the bottom or in the middle-income levels, the private plan should provide 50 or 60 percent replacement for the people making $100,000 or $200,000 a year. The private plan in fact, should produce an adequate income, what-

ever that is, at the low- and moderate-income levels. If we stop talking about Social Security as a benefit in the one-worker family, we might see that there is a gap that ought to be filled by the private plan before it is allowed to integrate.

MS. MAZO: I want to comment on changing family models and confused Social Security policy. The Social Security Act this year, in imposing taxes on one-half of Social Security benefits above a certain level of outside income, has imposed a "marriage tax" on married couples with two wage earners. Their income must be $32,000 (or $16,000 per worker) to incur taxes, whereas a family with only one wage earner begins paying tax at $25,000 of income.

I also want to ask why should a withholding tax be imposed on pension plans that pay no benefits above the presumptive withholding level? It is not the fault of the benefits community alone that its representatives have not been particularly effective in persuading Congress, at least within the last year or two, to draw responsible lines on the kinds of changes that it makes.

Problems in the Reform Legislation

MR. ALLEN: I do not recall any discussion of top-heavy provisions in the hearings on the Rangel bill or in subsequent legislation. That discussion seemed to emerge in the conference committee.[1] Many of us in the benefits community are concerned with this problem. Reform legislation that substantially affected the employee benefits community was enacted very quickly, and the communities involved had inadequate opportunity to testify. This is my view, and I know others share my attitude.

Let me give an example of the apparent shift away from "we shall not discriminate in favor of highly paid people" to "we shall discriminate in favor of lower paid." In designing TEFRA, planners voiced concern that executive shareholding employees were accumulating large estate values in private plans and taking advantage of estate laws. Hence, TEFRA has one provision that limits the estate tax exclusion to $100,000 and another provision that restricts the individuals who can be named as beneficiaries.

[1]Editor's note: The reference is to the Pension Equity Tax Act of 1982 (H.R. 6410), introduced by Representative Charles B. Rangel (D-New York) in the 97th Congress. Hearings were held by the House Ways and Means Committee on June 10, 1982 (Serial No. 97-65, 97th Cong., 2nd sess.); but the bill was never reported out of Ways and Means. Similar provisions were ultimately included in TEFRA, which originated in the Senate and underwent substantial changes in the conference committee (H. Rep. No. 97-760, 97th Cong., 2nd sess., August 17, 1982).

For example, suppose a General Motors executive wants to retire and wants to protect a handicapped child. The executive is now prohibited under TEFRA from making a joint and survivor election that would protect such a child.

The estate tax limitation of $100,000 could have been effective in handling this situation, but the new law represents overkill. If you happen to have been an executive who retired prior to TEFRA and planned your estate on the basis that an installment distribution was free of estate tax, and if you had made an irrevocable election counting on this, it is a rude awakening to discover that the whole value of that benefit to the survivor is now part of your estate, and there is nothing you can do about it. This is just another of the unfortunate results of the rapidly enacted legislation.

The Reasons Employers Provide Employee Benefits and the Influence of Tax Treatment on Employer Decisions

Harry G. Smith

It is clear that there is a great deal of concern among employee benefit professionals that Congress will enact new tax laws driven purely by the search for incremental federal tax revenues.

Historically, public policy has been formulated largely in a data vacuum; as a result, some of our laws and regulations do not make much sense. I support Everett Allen's views on the original Employee Retirement Income Security Act (ERISA) regulations on an "hour of service." They certainly do not apply to any industry I ever worked for.

By and large, we have a good system of providing benefits to the American worker. I am encouraged that groups like EBRI are coming forward with sound research and analysis and that they are being heard by the people who formulate public policy.

The opportunity for us to influence public policy through education exists today, as never before, through groups like EBRI. We can do sound research and reach sound conclusions regarding the current status of employee benefit programs and the implications of alternative policy adjustments. The job for all of us is to make every effort to share our views with people who formulate public policy. The benefits community can give more constructive guidance to Congress, and Congress can benefit from listening to us.

Why Do Employers Provide Benefits?

Many policymakers do not understand why employers provide benefits. They are initially shocked by how much of an employee's total compensation is in benefits. For medical benefits alone, the bill is enormous.

Benefits, of course, are designed to address the basic needs that arise from aging, death, illness, disability, and so forth. People also need to be able to cope with inflation after retirement, so I would add to that list the need to accumulate capital toward retirement.

Now, these programs have been developed over the years for a number of reasons. At one time or another enlightened management has been

pushed along by strong unions, federal legislation, socioeconomic factors, and employees' expectations.

Today, each industry has a set of benefits that have evolved over the years to meet competitive needs. Tax policy may have had very little to do with creating those benefits, but the situation will be different in the future.

Today, those of us in industry, spend a lot of time formulating corporate policy toward benefits. When we are preparing a presentation to our boards, we are particularly busy. We hire extraordinarily competent consultants to help us.

As a consequence, I think we have developed a highly sophisticated profession that is based on a sound philosophy and a good understanding of how policy is influenced. We all want to develop basic corporate programs that meet employer and employee needs. Even though we sometimes seem in danger of inundating ourselves with volumes of verbiage, we still produce good statements and sound programs.

What Changes Can We Expect in the Future?

As our economy matures, however, I predict that the emphasis will gradually shift back to basic health and retirement programs, with less emphasis on more exotic benefits. Adverse tax legislation will accelerate this shift. What really is the influence of tax policy on benefit decisions by corporations? In my experience, in the short term, tax policy has had little impact on the presence of basic programs, but it has affected program design. For example, in Canada a decade ago, disability benefits received favorable tax treatment if the employee paid the premiums. Industry merely shifted the cost-sharing pattern to accommodate this legislation. The programs remained the same.

The problem is that in the long term adverse tax legislation can affect not only the design of a program, but also the type of program and even the existence of a program. The big argument today that comes about largely due to government actions is over the defined benefit pension plan versus the defined contribution plan. Current public policy appears to favor the latter. I believe that this is a mistake and that, in time, a shift to defined contribution plans will adversely affect many American workers. I am not referring here to workers in the Fortune 500 companies or to workers at the other end of the scale in very small organizations. I mean the majority of American workers today, those between these two extremes.

What Are the Effects of Benefits?

I have been asked to assess the effects of benefits on employee retention, productivity, cost efficiency, and other human resource issues. The effects vary from company to company, industry to industry, union to union, but overall the effects are good. If you have a good program to begin with—one that meets the needs of employees at various income levels—and if you manage this program well and have a lot of luck, the benefit programs have positive human resource values in each of the areas just listed.

Why Not Let Employees Provide Their Own Benefits?

I have also been asked to comment on why employers should provide benefits as opposed to paying employees in before- or after-tax dollars and allowing the employees to provide their own benefits. I believe it is psychologically unsound to assume that human beings, if left to their own devices, would indeed provide themselves with logical, sound, cost-effective, integrated benefits. When I was eighteen or twenty-five, I am sure I would not have done it. It is important for an employer or some central source—it can be a union—to provide structure and leadership, as well as economies of scale and time.

Let me add that we need better understanding and cooperation between industry and the federal government. Our collective goal should be to create a fabric for economic security. Sometimes we get so involved in the technical details—the ramifications of tax structures—that we lose the broad perspective on the purpose of benefits.

Defined Benefit versus Defined Contribution Plans

There have been many discussions on defined benefit and defined contribution plans. Almost any position can be justified, but I think the matter is quite simple: at the end of a career, the goal is income maintenance. I think if we had a better understanding and coordination we would do a better job of achieving this goal.

There is a definite trend toward defined contribution plans. Defined benefit plans are being discouraged through public policies, such as some parts of ERISA, and through the tax laws of 1981 and 1982. The private Financial Accounting Standards Board is also discouraging defined benefit plans.

Conflicting influences in today's society will affect the design of benefits. Young workers want mobility. There are many two-worker families. The government is pushing up the retirement age, while the real world is pushing it down.

All these things combine to make it easy for employees to demand defined contribution plans and for the employer to supply them. But the result could be an unsupportable public burden.

The problem is that when each person leaves employment with a defined contribution plan, the person receives the value of the plan account at that time; the level of benefits may be affected advantageously or disadvantageously by the stock market prices. People whose benefits are depressed will have to live with a depressed benefit for the rest of their lives. I believe this situation places the public at risk to respond to political pressures with Social Security and Medicare. In the long term this may create new financing problems for those programs.

Defined benefit plans offer employees greater retirement security. Therefore, this type of plan also makes more sense from a public policy perspective.

The Integration of Private Plans with Social Security

Integration of private plans with Social Security, in some form, is here to stay. There is just too much money being paid in payroll taxes and in Social Security benefits for the program to be ignored in providing retirement income. Consequently, public policy should encourage rather than discourage both explicit and implicit integration.

Summary

I believe there will be tax changes in our benefits world. The benefits community and groups like EBRI should conduct the necessary research to enable us to supply facts to the policymakers and urge them to handle the problems effectively.

I urge restraint on the policymakers, restraint similar to that of a farmer I know who has a peg-leg hog. When somebody asked the farmer about the hog, the farmer said, "That's the greatest animal in the world. Last spring, when my three-year-old daughter was playing around the pool by herself, she fell in, and that hog went in and saved her." The farmer added that the hog had done several other equally meritorious things, at which point the other fellow said, "Yeah, but tell me about that peg leg." The farmer answered, "Oh, with an animal as valuable as that, you don't eat him all at once."

An ongoing series of policy changes that adversely affect employee benefits may not allow us to see the peg legs until it is too late. American workers will be the ultimate losers should this occur.

Discussion

Who Pays the High Cost of Benefits?

MR. MELTON: I want to return to the subject of benefits and their high cost—the proportion of total pay that they represent. I heard recently that tax-favored benefits represent over 16 percent of total pay.

The first question is who pays for these benefits? I have to assume that the employees pay or the employer pays for them, but in either event the cost is taken into account in determining the total wages of employees.

It seems clear that these benefits are not a gift. If they're not a gift, what is the problem? Do the employees not value these benefits enough? Is the problem that they do not give employees a present value or an internal value that is equal to the real cost to the employer? Or is it that the employees are coming to think of these benefits not so much as compensation or payment, but as a right, some minimum level of protection?

MR. SMITH: No doubt you remember Allen Barkley's story about ungrateful constituents. Over the years Barkley did everything he could for a man who, when asked for his support at the polls, said he was not going to vote for Barkley. When Barkley asked the reason, the voter responded, "But what have you done for me lately?"

That ingratitude can be true in industry as well. You may develop and implement good benefits, perhaps 30 to 35 percent of payroll in some industries, but if you do not manage things well, the only thing the employees will ask is "What's new?"

The needs of employees vary with age. Benefit plans must be structured to meet these differing needs and expectations. They must also be managed and communicated effectively to maximize their value and impact with employees. Otherwise, employees will view them as an entitlement.

Should Private Plans Have Provisions for Loans?

MR. HALPERIN: I have heard concern expressed about how the defined contribution plan tends to lead to earlier payouts, and about whether loans should be allowed from pension plans.

There have been efforts to curtail the use of loans, certainly loans without current tax liability, from private plans. Certainly we could discourage, if not prohibit, early distributions by getting rid of the special treatment of lump-sum distributions. If one wants to talk about complexity of the tax law, that is a good place to start.

Yet, that kind of legislation has not been enacted because many people are clearly interested in loans and not interested in retirement savings. They just want special tax benefits. If these practices are causing problems—if assets are not being used for retirement—should we not expect greater efforts to tighten these rules so that "retirement income programs" truly become retirement income programs?

MR. SMITH: Yes, I think the rules should be tighter. You might be interested to know that we have had a stock purchase plan at Sun Company since 1926. We have put in a trust option for the company's share, and we have had a hardship clause.

I believe there has been one payout under the hardship clause in that entire period. The reason is good management. We care. We counsel our employees to try to find alternatives to financial hardship distributions. The one payment we made was in a case of terminal illness. The employee's financial affairs were in bad shape, and we made the payout because he was going to die. Generally, however, I do not see great need for loans.

A company can design the plan for the purpose of retirement, and if it is managed well, the employees will go along with it. If you start a new program in a relatively uncontrolled way and make loans available for all purposes, you will have lots of yachts in your backyard.

The Effects of Changing Demography in the Work Force

MS. KORCZYK: I want to ask Harry Smith a question relating to the changing demographics of the labor force. Right now, the people in their prime earning years are in the baby-boom generation; this group is being followed by the baby-bust generation. In practical terms, that means that twenty-one-year-olds are going to be relatively scarce compared with thirty-five-year-olds in the near future. Do you believe the changing demography will have implications for the role of benefits in human resource management? Do you think this factor is important in how you recruit and retain a work force?

MR. SMITH: Yes. These groups have different needs. The baby-boom generation is large, and management is going to pay attention to the needs they express. For example, I think the climate favors defined contribution plans versus defined benefit plans. This group will want loan features and more liquidity. Their expectations will not relate to retirement income. This will create problems for employers and the government.

Base Plans versus Supplemental Plans and the Government's Involvement

MR. ALLEN: I want to comment on Dan Halperin's point about the use of loan provisions and the concern we have about the resulting erosion of retirement plan assets. In the benefits world, most organizations deal with a combination of base plans and supplemental plans. The issues are totally different if we are talking about a supplemental defined contribution plan.

If the defined contribution plan is the sole, basic retirement program, it is important to consider the need for preserving the ultimate purpose of the money for retirement income instead of using it prior to retirement. This issue needs to be addressed, but in doing so, we need to distinguish between base plans and supplemental plans. There is a difference.

MR. HALPERIN: If you are saying that some plans that are treated as retirement plans under the Internal Revenue Code are not really retirement plans, then you really have to ask why the tax code should treat them more favorably than other forms of savings.

We are purporting to say that special tax treatment is limited to savings for retirement and does not include savings to buy boats at age forty. If we then say we do not have to worry about supplemental profit-sharing plans per se, because they really are not for retirement and some of the rules are therefore not appropriate, do we then have to go further and say that we should not tax favor the supplemental profit-sharing plan at all? Why pretend that we are talking about retirement savings in terms of these special tax benefits?

MR. BAITSELL: I think that there is a need for both types of plans. I would suggest that problems arise because we have the *tax* people on Capitol Hill looking at benefits policy rather than the *benefits* people. My feeling is that we should not be coming down hard on the side of either the defined benefit or the defined contribution plan. And, we should not be making benefits policy based upon concerns over tax revenues.

MR. MELTON: What is to prevent your employer from using nontax-favored benefits? If the "tax people" are looking at benefits, it is because they are looking at the tax treatment of benefits. If these benefits were not treated in a special way—if they were treated in the same way as any other kind of compensation—employers could do anything they wanted to do, couldn't they?

MR. BAITSELL: I suppose I look at the problem over thirty or forty years. The country has developed a very fine tax-qualified benefits system. If

there are obvious abuses, as somebody said, they ought to be ferreted out. I am reluctant for the government, however, to get involved in every aspect of savings plans, profit-sharing plans, and pension plans in a revenue-raising mode. On balance that interference will do more harm to the system than the abuses will. Harming the system harms American workers.

MR. MELTON: I am less concerned with the revenue-raising mode—although that seems to be driving most of the interest in employee benefits on the Hill right now—than with your focus on the problems associated with the government's getting into every aspect of qualified plans.

If we assume that the current rules applied to qualified plans are a kind of government expenditure for retirement savings, what would the rules be like if instead of allowing these benefits through the tax system, the program were administered by the Department of Commerce, for example, as a capital formation device, or by the Department of Health and Human Services as a retirement device?

The kind of requirements that these departments would impose would differ considerably from the tax rules, and the "interference" that would follow would dramatically increase. Perhaps if the tax-benefit rules are viewed as providing a subsidy, it is logical to conclude that the government is going to regulate the way these benefits are provided.

You do not have to use the tax system to get savings. Some would disagree, but if the tax system is used to allow a particular kind of benefit, then its function becomes not simply revenue collection but regulation. Tax rules and regulations describing and limiting plan operations are the price of these favorable tax benefits.

MR. BAITSELL: If we could transfer regulation of benefit programs to the Commerce Department, we would be very happy.

Do Taxpayers Want More Control over Pension Funds?

MR. FERRARA: I am with the National Taxpayers Legal Fund, and I want to say that from what I have perceived the viewpoint of the country's taxpayers to be, some of the commentary here certainly seems to be going in the wrong direction. Taxpayers seem to think that their control over the funds in these accounts ought to be expanded rather than cut back.

There is a need for a dramatic increase in savings and capital formation in this country, and there ought to be a safe harbor where people can put money to be used later for housing, education, retirement, health care, and the like.

In the future, the focus should be on finding methods to expand options rather than on methods to limit them. That is more in accord with public opinion as we see it.

MR. SALISBURY: This point of view is somewhat similar to Harry Smith's interpretation of some of the changing demands of employees that may come from the demographic shifts. I would be curious as to whether Peter Ferrara or Harry Smith thinks that individual workers are going to start getting involved in the debate over benefits or whether they will remain totally oblivious to the policy debate.

To What Extent Will Workers Participate in the Debate over Benefits?

MR. FERRARA: I think there is a tremendous potential for action by workers. People are beginning to become alarmed about the apparent government efforts to go after private pensions and private retirement savings in an attempt to increase revenue. Policymakers have been surprised at the amount of mail that has been received; I think this issue could create a blizzard of mail in the halls of the Capitol.

MR. SALISBURY: So you would suggest that the only reason that workers have not been active in the past is that nobody had told the workers that they should be concerned?

MR. FERRARA: Yes. In addition, communication is a key factor, and new channels of communication have been developed. There are new organizations which have developed channels of communication to people in the countryside who often do not hear about events until they have already happened. The new communications technology in place will alert people more quickly to what is going on.

MR. SMITH: I agree that communication has improved. I believe that people generally will respond to perceived problems, and that American workers today are aware of the perceived weakness of Social Security.

If all of us are more alert to the problems, we will become more vocal. Conversely, if workers perceive that these matters are well in hand, they will go fishing.

MR. COWLES: We have the beginning of a basis for trying to determine whether the work force will get involved in the matter of benefits: deductible employee contributions, which are now permissible under an existing employer-sponsored plan, for the first time have put employers in competition with outside vendors for the benefit dollars of their own employees.

Our experience at Bankers Trust Company indicates that the typical corporate-sponsored vehicle to capture individual retirement account (IRA) contributions is getting only a 10 percent participation. Does this mean that only 10 percent of those employees are setting up IRAs or that 90 percent of them are setting up IRAs on their own?

If we can discover the answer, we may have the beginning of a capability to capture statistics on whether employees will, in fact, take care of their own retirement.

MR. HIRSCHLAND: I am here today from the United Auto Workers (UAW) union. I take exception to the suggestion that individual workers do not have any involvement or representation in the benefits-policy process.

MR. SALISBURY: I did not say representation. I am talking about individuals acting on behalf of individuals. There is plenty of representation through the union.

MR. HIRSCHLAND: I am having some difficulty understanding exactly what kind of participation you were thinking about.

MR. SALISBURY: With respect to issues associated with the Tax Equity and Fiscal Responsibility Act (TEFRA), Congressman Rangel noted that he got almost no mail on the subject from individual workers. The only mail he received was from representative organizations like the UAW or employers, which he did not really count. He deduced, therefore, that individual employees really were not being hurt.

If our politicians take the view that they will only be influenced in the future by the kind of outpouring of mail that has been prompted by the withholding debate and similar issues—that mail from the representative organizations is to be disregarded—can we expect an outpouring of mail from individual workers on the subject of benefits? Can organizations like yours cause that outpouring at the individual employee level, rather than through the traditional mode of representation in these debates?

MR. HIRSCHLAND: When individual employees believe they are going to be affected, we will see that kind of response. As for the changes in the Rangel bill which were incorporated in TEFRA, that issue does not particularly affect our constituency. If you hit on an issue that directly affects the people we represent, I believe you will hear from them.

MR. SALISBURY: What is happening with respect to the taxation of health benefits?

MR. HIRSCHLAND: We have been very active in that area, and Congress will probably be hearing from our membership.

The Implications of Proposed Changes

MR. SCHIEBER: Part of the problem with getting a groundswell of support or opposition to some of these provisions is the inability to explain what the implications are over time. I keep coming back to the Bradley-Gephardt bill and the new section 415 limits it proposes. The bill includes limits of $20,000 and $60,000. Let's assume you have a limit of $60,000 on a defined benefit plan that you can fund. The rank-and-file workers and taxpayers of this country are unlikely to write or call their members of Congress to tell them it's somehow unfair to reduce the benefits that can be funded from $90,000 a year to $60,000 a year under the tax provision.

The other provision in that bill would freeze those limits and make no provisions whatever for indexing them. Let's return to an inflation assumption of 7 percent, because it is simple and somewhat less than what we have experienced over the past twenty years. For a forty-five-year-old worker, the maximum benefit that can be funded in 1983 dollars is $15,000 per year; and for a twenty-five-year-old worker, the maximum benefit is $3,750.

If the taxpayers in the country understood this situation, most of them would probably be upset, but I do not know how to convey this message to them in order to arouse them. Over time, such changes could ravage the system that is supposed to be supplementing Social Security, which has its own problems. I do not know how Peter Ferrara is going to get his constituency to handle this.

The Discriminatory Effects of Tax Shelters

MR. SMEDLEY: I am with the AFL-CIO. I want to comment on Mr. Ferrara's statement that the taxpayers want a larger variety of tax shelters for education and various other purposes. Any time you use the tax code to help people in that way, the result is inherently discriminatory. These tax shelters will not help the average worker, and the lost revenues will have to be made up in some way. Most of the money will go to higher-income people—which brings me to the question of the original purpose of tax-qualified employee benefit plans.

These plans were originally created in the hope that employers would provide benefits for the average worker, who would then get some protection in this way. The aim was not to give tax shelters to higher-income people. My point is that our workers are not concerned with many of the issues being discussed here, and to the extent they would be concerned, it would probably be in their self-interest to oppose the proposed private pension legislation.

In contrast, consider the question of Social Security; a very large constituency of workers readily made Congress aware of their views and their action was very effective. The workers do not perceive that they have as great a stake in private pension legislation as they do in Social Security; that is one reason the Social Security reform legislation moved through Congress the way it did.

The Appropriate Roles of Individual Workers and Employers in Retirement Income Plans

Michael W. Melton

Mitchell Polinsky opens his new book on law and economics by telling of a physicist, a chemist, and an economist who land on a desert island and find a can of beans that has washed up on shore. The physicist says, "If we throw this can of beans twenty-three feet in the air, the terminal velocity when it lands will be just enough to burst the seams." The others say, "No, that will spill the beans." Then the chemist says, "If we heat the can for thirty-seven seconds, that will be just enough to open it up," and the others say, "No, no, the beans will land in the fire." So the physicist and the chemist ask the economist, "Well, what do you propose?" And he says, "That's easy; I assume a can opener."

I am going to start with an assumption and, I suppose, a candid recognition that I am an unreformed income-tax person as opposed to a consumption-tax person. I am reminded of another story that is attributed to Senator Russell Long. A jealous Frenchman who thinks his wife is having an affair comes home early one afternoon. He smells cigar smoke in the apartment, and he runs all through it searching for somebody, without success. Then he looks out the window; five floors below standing next to the building is a man smoking a cigar. The Frenchman is so incensed that he pushes the refrigerator out the window and it lands on the man five floors below.

The scene shifts to the pearly gates where St. Peter is facing three men. St. Peter asks the first man, "How do you come to be here?" and he says, "Well, I'm a janitor in a building and I was smoking a cigar on my break. All of a sudden a refrigerator landed on me, and I woke up here."

St. Peter turns to the second one and says, "How did you get here?" He says, "Well, I was a jealous husband, and I was pushing a refrigerator out the window when I had a heart attack, and found myself here." Finally, St. Peter turns to the third man and says, "How did you come to be here?" The third man says, "I was smoking a cigar inside a refrigerator. . . ." I think that story is useful to introduce questions about how the income tax system got to be the way it is.

Reasons for Special Provisions in the U.S. Tax Code

Under our system, income is included in the tax base whether it is spent at once or saved for a rainy day. Immediately, we can all think of exceptions to that rule. We do not tax unrealized appreciation in stock or in real estate, an exception that is particularly difficult to justify with respect to publicly traded stock. We do not tax interest on life insurance savings. We do not tax interest on state and local bonds, or on bonds issued "on behalf of" those entities. A number of reasons are usually proposed for these exclusions. How did we get our current system? With respect to the exclusion of unrealized appreciation, the most common reason is the administrative difficulty of determining the amount to include in income. Trying to determine the value of a piece of undeveloped land, for example, is a very costly process.

The process costs—and taxpayer dissatisfaction—would also be high if we were to try to include in the income tax base imputed income from services. Lawyers sometimes perform a service for a relative for free or at a low price; most of us lawyers would find it obnoxious to be required to include the imputed income from that service in our tax base. Certainly that would be the case with respect to nonwage-earning spouses who work at home. It certainly seems to be the response when we talk about imputed rental income.

There are other reasons for some of these special provisions in the tax code, one of which is the attempt to use the code to provide incentives for certain kinds of programs.

One of the problems with this incentive approach to the code is the argument that it is not an alternative to a direct program. In fact, one of the arguments I have read against viewing the code as an alternative to direct expenditures is that the Department of Commerce, for example, would never have a program in which all one had to do was fill out a form that said "We have a pension plan that covers 70 percent of our employees, and we contribute money to it. Send us a government check for 46 percent of our contribution to the plan."

Congress would, I suppose, have a much more detailed set of rules if a retirement income system were administered by another agency. I do not mean to suggest that the rules in section 401 through 416 of the code are simple, but the process would probably be much more complicated and detailed in another agency. Therefore, some people say, "Well, you can't compare the tax system with direct programs." I think that view is wrong. There are different ways of achieving the same goals, and the differences between tax incentives and direct programs do not alter the question of whether the tax system is the most efficient way to achieve these nontax-policy goals.

Are the rules relating to qualified plans subject to this analysis? The *qualified plan rules are no big deal*. An employer deducts compensation whether or not it is paid directly. Employees eventually include these payments in income, subject to the minimum distribution allowance, rollovers to individual retirement accounts (IRAs), and all those kinds of footnote exceptions. So what's the big deal?

I think the big deal has two parts. One part is timing. The employee does not include compensation in income until it is distributed from a qualified plan. Second, the trust is exempt from tax under section 501(a). The timing difference is, I believe, the equivalent of an interest-free loan to the employee. Suppose I have other income, so I pay a 50 percent marginal rate on each additional dollar earned. If I receive $100 for mowing the grass in my neighborhood, I pay $50 tax on that and I have $50 to invest. I invest it at 10 percent, get $5 of income after one year, and pay 50 percent tax on that, so I have $52.50 in hand. Alternatively, the government gives me a loan of that $50 tax payment in year one, so I have $100 to invest, and I invest that at 10 percent. One year later, I have $110—$10 of income and $100 of invested capital. I repay the loan and pay tax on the $10, so I now have $55. The effect is the same as a tax-exempt return on what would have been the after-tax amount earned in year one. This loan is the same as deferral of tax in year one and has the same effect as the qualified-plan rules. In addition, if the tax rate is lower in the second year, as it may be with some retirees, the transfer of benefits to the employee is significantly greater.

So for this purpose, we can assume a can opener—we assume that tax benefits for qualified plans do exist, that the current treatment under section 401 is not a normative or an ordinary way to treat compensation, and that a benefit is being provided through the tax system.

An argument made to justify special tax provisions for retirement savings is capital formation. I think that if we are really interested in capital formation alone, there are much more effective ways of forming capital than providing for tax-favored retirement savings. Indeed, the fight over the collectibles limitation for IRAs suggests a mixed view about capital formation and retirement savings. There currently are other, more direct ways within the tax system intended to spur capital formation. The Accelerated Cost Recovery System and the investment tax credit provisions are, at the least, intended to be direct incentives to increase capital.

If we assume that capital formation is not the central reason or a sufficient reason or an appropriate reason for special tax treatment of retirement savings, what are the reasons? Why do we have section 401? Why defer tax until the income is spent; why not include it as it is earned?

Social Goal as a Justification for Special Treatment of Retirement Benefits

The justification for this special treatment is not in the tax laws; it is a nontax, social policy goal. I think the goal is to assure that employees at all income levels will be provided with retirement income protection, protection that is particularly difficult to plan and save for at the low- and middle-income levels. It is as though the code holds out a lever and says to the employer, if you want to have the satisfaction, the rewards for your highly paid employees from this tax-favored retirement benefit, you must bring along a substantial number of the rank and file. The code says, in effect, "We will allow this special tax treatment if the plan provides broad-based coverage and nondiscriminatory benefits." Indeed, the basic 70 to 80 percent coverage rule and the basic antidiscrimination rule have been in the code since 1942. This is not really a new idea, at least this part is not. But, if that is the basis for section 401, how did we get section 219 allowing individual deductions for contributions to IRAs?

IRAs: An Upside-Down Subsidy

IRAs certainly are a departure from the prior income tax rules, and they are a departure without the qualified plan lever, without the ability to cause savings, even forced savings, for low- and moderate-income employees. It is as though the Treasury, in supporting the expansion of IRAs in the Economic Recovery Tax Act (ERTA), testified, in effect, that we have a program for the Commerce Department; we want to subsidize savings. What we propose is to have Congress give an interest-free loan of 50 percent of the amount saved for taxpayers who earn, let's say, over $50,000; and an interest-free loan of 40 percent of the amount saved for taxpayers who earn, let's say, $40,000; and an interest-free loan of 25 percent for those earning $15,000. For people who do not pay any tax, however, we are not going to give any loans at all. They will have to save entirely out of their own pockets. I have a lot of trouble with this approach in a supposedly fair income tax system.

The effect of the "upside-down" subsidy is reflected in the actual use of IRAs. The statistics on current use of IRAs are essentially the same as the statistics before the provision was broadened in 1981, that is, the utilization rate is much higher—as much as ten times higher—at the highest rates of income. People at the lowest levels of income apparently have a real inability to save. This inability is not influenced at all by tax provisions when the people are going to pay tax only at an 11 or 14 percent rate. From the upside-down effect of IRAs, I conclude that it is inappropriate to

have individual choice replace the qualified plan "lever" in the code. The question has to be, "What are you going to do about it? Get rid of IRAs?" Although that is one approach, what else can you do? If the qualified plan rules are designed to be a lever to provide for retirement income protection at low- and moderate-income levels in particular, is the absence of individual choice enough?

Some Radical Solutions

There are at least two radically different answers to this "choice" question. One answer reemphasizes individual choice. It is based on what some people call the comprehensive tax base—an expanding tax base approach—and it would repeal section 401 along with most other special deductions, credits, and exclusions. At the same time, it is hoped, rates on income would be drastically reduced.

It is expected that such a maneuver would increase horizontal equity, that is, similarly situated taxpayers would be treated the same. This maneuver would increase incentives to work, because the lower tax rates would make leisure, in a sense, more expensive. Because the return on investment would be greater, this maneuver would increase the incentives to save and increase peoples' willingness to take risks.

I think, however, there is a problem of perception here. On the one hand, it is very difficult for low- and moderate-income employees to save for retirement. On the other hand, I suppose that proponents of a comprehensive tax base could say, "Look, we're going to give everyone a low tax rate, and they can do with it what they want." If they don't save for retirement, the response could be, "Let them eat brioche when they get to be age sixty-five."

I do not believe that Americans today, however, are willing to take that kind of attitude. Instead, we expect to take care of the elderly without regard to how they spent their incomes before retirement. Hence, taking a comprehensive tax base approach would only lead to more problems in this area. If exclusions, deductions, and credits are eliminated so that individuals must independently decide to save for retirement, that is certainly going to cause some trouble.

Another radical approach as an alternative to individual choice is to adopt a minimum universal pension system—"MUPS." This would create substantial problems for small businesses, however. The administrative costs of establishing a plan, and the effect on marginal profits for those companies, could be prohibitive. We would lose the benefits these companies bring to the country.

Some Less Radical Solutions

A third alternative, perhaps not so radical as MUPS, is to adopt a progressive tax based on consumption. Under this approach, you would measure all income, subtract all savings and all new investments; what would be left would be "consumption."

Two problems arise with the consumption tax approach. One is its distributional effect. If people at the low end of the income scale have to use all their money to buy basic necessities, and thus have no money to save, they may bear a substantial, disproportionate burden from the consumption tax.

Second, there would be no special provisions for retirement savings in a consumption tax, unless additional credits for special kinds of earmarked savings were included. The absence of special provisions would raise the same problems as noted in a comprehensive tax base system; the inclusion of special credits would raise the same issues we face with the current system.

One other alternative—less radical than the comprehensive tax base, the consumption tax, or a minimum universal pension system—is to tinker with the current system. I think that we see a lot of tinkering now in terms of establishing the employer as either dictator of benefits or facilitator of benefits.

For example, the government usually is neutral in employee benefit provisions as to the kinds of plans adopted and the investment mix of plan assets. Except for the limits imposed by the fiduciary responsibility rules under Title I of the Employee Retirement Income Security Act (ERISA), a plan may be invested in anything. Employee stock ownership plans (ESOPs), however, move substantially away from this portfolio neutrality, providing that the plan shall be invested primarily in the employer's stock. But this puts the employees in a position that is worse than that of an unsecured creditor of the company. Therefore, I think substantial questions arise as to whether these plans should be in the retirement plan provisions of the code. They may have terrific effects on the firm and on productivity and worker morale, but they may not be appropriate in the code's retirement plan provisions.

Tinkering at a more substantial level than investment neutrality is possible, of course, particularly in deciding between the employer as plan sponsor and allowing individual choice by employees.

Much of the regulation of plans today is based on the 1942 concept of discrimination, which says that the plans must provide benefits to the relatively low-paid group. If you have a plan with 100,000 participants, 30,000 of whom are vested, and 20,000 of the vested group are earning,

let's say, less than $15,000, then under current rules, that plan is not discriminatory because two-thirds of the benefits are going to relatively low-paid people. But what happened to the other 70,000 participants?

One possible alternative to this relative benefit approach is to say that, notwithstanding apparent employee choice about the value of deferred compensation, we should look at absolute benefit delivery. The code could require that employers shall provide benefits to a broad cross section of employees.

This leads me to my last question: who's going to pay for this? If employees think they are going to work for less than ten years in a ten-year cliff-vesting plan, I doubt that they would rationally accept a reduction in their current compensation as a trade-off for plan participation. The employer could not say, "You're going to participate in our plan after one year, so we'll pay you less now than we would have paid if we didn't have the plan." The employee who thinks he or she is going to leave within ten years is not going to accept that argument.

So it does not seem that the contributions on behalf of those people, although they will forfeit their benefits, are really being used to fund the plan benefits. Perhaps the real funding comes from the employees at the later ages. Employees become more interested in saving for retirement as they get older, when retirement becomes more of a reality to them. If older people are the people who are really paying for the plans, then perhaps individual choice in terms of time of participation could work out well for both sides. If the employer is not expected to pay a thirty-year benefit accrual after just ten years of service, and if employees are not prohibited from working because they are reaching a point where faster accruals are necessary, perhaps a mutually beneficial arrangement with actual rather than relative delivery of benefits can be worked out.

Discussion

Tax Incentives or Exemptions versus Government Loans and Grants

MR. FERRARA: I found this discussion to be an interesting philosophical journey, but there are other ways of viewing the income tax code. I think that many people would see a difference between a tax incentive and a loan from the government. With a tax incentive you are merely allowed to keep money that you had earned in the first place, whereas when you get money directly from the government, you did not have to earn it in the first place. The government takes it from someone else and gives it to you.

Therefore, in the case of a tax incentive under a different philosophical view, you have a valid claim on the money that you are being allowed to keep. The question becomes not so much why that money should be tax exempt, but maybe why it should be taxed in the first place. Many taxpayers question why, when they are trying to set aside assets for their retirement, for example, the government should step in and seize those assets and redirect them to other uses.

If we have a fundamental social agreement that we want to prevent the imposition of government obstacles in the way of people who are attempting to achieve adequate retirement income, we ought to face that question in those terms.

While we are talking more about philosophy than about tax policy, I want to make another point. I find it strange that people complain that tax advantages give higher benefits to higher-income people. Those same people should have a philosophical problem with aspirin as well, since it provides bigger benefits to people with bigger headaches.

MR. MELTON: If we wanted to give benefits to soldiers who serve in the combat zone—if we say that they deserve special treatment because they are serving the country in combat—one way to do it would be to give them extra cash, right?

MR. FERRARA: Yes, but that is not a good example, because soldiers in the combat zone are employees of the government, so they are already performing a public service.

MR. MELTON: If we wanted to give benefits to the clergy, then, the government could give money directly to ministers; we could subsidize

them through government grants. That would be one way of providing an incentive to people to be ministers—the fact that there would be a special benefit flowing from the government.

Another way to provide that same benefit with different distributional effects is to exclude from income the value of parsonages provided for ministers. This treatment, exclusion of the value of parsonages, has the same effect as collecting the tax from a minister and then having some other agency provide a direct grant back to the minister.

What I am trying to point out, in terms of the income tax system, is that under an income tax "clean slate," income is included in the tax base when it is earned. Clearly, the tax treatment of employee benefits is an exception; the policy does not assume that the government owns all the money. The effect is the same as it would be if we were to tax all employees on their benefit accruals as they became vested, and then the government—the Commerce Department, for example—turned around and wrote them a check saying, "We want to subsidize this activity—we want to give you incentives—so we're going to give you this extra benefit for engaging in this kind of behavior."

MR. FERRARA: Let me address that point. I think the clergy is a good example because the Supreme Court has considered exactly the kind of case you are talking about. In the case of *United States* v. *Walts,* the Supreme Court upheld the tax exemption for churches by recognizing this precise distinction. A grant to a church and a tax exemption for a church are not the same in every respect, although they may affect economic activity in the same way.

In the case of a grant, you have to take money from other taxpayers and give it to the minister; in the case of a tax exemption, you are merely allowing ministers to keep the money they have received through voluntary contributions or earned by the services that they provide to the people in their congregations.

It was that precise distinction that all members of the court used to justify the constitutionality of the tax exemption.

A Question of Perspective

MR. HALPERIN: I have been listening to Peter Ferrara, and I am not really sure what the proper response is. To come to the point, I think that whether the action is viewed as a penalty for one way of doing things or as a subsidy for another way, we still must decide whether as a matter of public policy, we are going to favor one approach over another.

I think Peter Ferrara is confusing two issues. Sometimes he seems to be saying that a consumption tax is the best approach, and the people ought not to pay any tax on the money they save. Obviously, many people believe that, and whether they are right or wrong is an issue that can be debated at length.

The second issue relates to the income tax. By saying "With a tax incentive you are merely allowed to keep money that you had earned in the first place," Mr. Ferrara is suggesting that the decision not to tax income spent or invested in a certain way does not require the same analysis as a decision involving direct government spending.

I am not sure what the difference is; presumably, it relates to using money for a public policy purpose. We are saying that even though we have an income tax, we are not going to tax income spent for health care or used for retirement savings or invested to build low-income housing or whatever.

We are making some judgment that the income is being used in a way that furthers public policy. I believe that the level of that judgment should not be different from the level of the decision on direct grants.

I do not think Peter Ferrara is suggesting that no public policy issue is involved. He is not saying, "It's the worker's money, and we ought to let them keep it for whatever purpose they want." He is suggesting, I think, that some public policy is involved in how this worker spends the money. He may be trying to dance around on the head of a pin in suggesting that the level of proof or the level of importance of that public policy is somehow different from what it would be if there were direct government expenditures. It seems to me, however, that once we have decided to have an income tax, the issue is the same in either case.

The Need for Fundamental Tax Reform

MR. ENTIN: I would like to move away from the details and focus on the fundamentals of what I think the country ought to be trying to do. I think the can opener does exist; it is entitled the *Blueprints for Basic Tax Reform*, which the Treasury Department published in the last weeks of the Ford Administration.[1]

We have not "decided" to have an income tax. We do not now have a broadly based income tax; we have a mixture of an income and a con-

[1]Editor's note: The study cited includes a wide-ranging discussion of theoretical and practical issues in basic tax reform. See U.S. Department of the Treasury, *Blueprints for Basic Tax Reform* (Washington, D.C.: Government Printing Office, 1977).

sumption tax. In special areas an effort has been made to avoid the fundamental double taxation of savings (which is future consumption relative to current consumption) that an income tax produces. These areas include pensions (with the deferred taxation and partial exemption), housing (with the implicit services of the owner-occupied home which tax policy has been trying to zap for years), insurance, IRAs, and capital gains (which no civilized nation treats as real income).

Our tax code is biased against capital accumulation. It has produced a capital stock much lower than the stock that the neutral tax code of a pure consumption base tax system would produce. It has lowered our incomes and the incomes of workers at the lower end of the scale in particular; this problem has been of great concern to people who design pension systems.

If we actually went to a broadly based income tax and made the bias against savings all-encompassing, so that everything people saved would be subject to a double tax, clearly the rate of return on savings would go down; now, at least, there are some areas in which double taxation can be avoided, so even with a more broadly based income tax, the rates on savings would be higher than the current rates on pension, housing, insurance, IRAs, and capital gains.

From the larger perspective, we find that the savings industry and the pension industry have an important role to play—a role that is thoroughly justified in economic theory in that a broadly based income tax would, in fact, be biased against pensions. Pensions ought to be getting even more favorable treatment, not less. Were this the case, the nation would be better off.

MR. HALPERIN: There is no general agreement that a consumption tax would increase the level of savings over the level under the current income tax system. That argument, however, has been made for many years. Some people think the difference would be slight, while others think the difference would be great. It is a lot easier to go along with the argument when you state it as fact, than when you state it as opinion, which it is.

The Flexible Approach to Taxable and Nontaxable Compensation

Daniel I. Halperin

Flexible compensation: how does it fit? I assume, first, that we have decided that we want to encourage people to spend money in a certain way. I am not going to judge whether that policy is sensible or not.

I accept for now the assumption that the only politically acceptable way of providing an incentive is through the tax system, rather than through some kind of a direct expenditure subsidy. That presents a dilemma. Tax incentives are not well designed to promote the type of spending or savings we are interested in by low- and moderate-income people, who are the people least likely to make the desired choices on their own. The price change for them, as compared with what it would cost to take a vacation, for example, is relatively small compared with the price change for high-income people.

Employer Intervention to Achieve Broad Participation

If we really want the incentive to work, we cannot leave the matter of participation to individual choice because low-income people will not respond to the tax incentive. The only way to achieve broad participation is through employer intervention—ideally, employer intervention based on some nondiscrimination test.

If the employer makes the choice, however, the employees will not necessarily receive compensation in the form they desire, or even in the form that one would objectively determine (as a big brother) that the employees should desire. Compensation may be provided in a form that does not make sense for particular employees. So we have a need for employer choice or dictation in order to assure that the incentive works at the low- and moderate-income levels. If employers become dictators, however, we may not obtain the wisest choice of benefits.

The Utility of the Flexible Compensation Approach

The flexible compensation approach—as evidenced by section 401(k) for cash and deferred profit-sharing plans and section 125(d) for cafeteria

plans—attempts to resolve this dilemma by retaining the favorable tax treatment, even though there is employee choice, as long as nondiscrimination results in practice. Whether it is employer pressure, education, or facilitation that causes this outcome is unimportant so long as we are satisfied with the practical outcome.

I might point out that this nondiscrimination must be in actual enjoyment of the benefit. If we look for nondiscrimination only in the opportunity to enjoy the benefit, then we are back to complete employee choice, with the kind of results that one would expect from reliance on employee choice.

I think this approach has merit. The real question is whether it can work as well in practice as might be suggested in theory. In particular, I want to concentrate on whether this approach makes sense in the context of cash benefits, like child care or reimbursement for medical expenses, as opposed to the purchase of insurance.

When section 125 was enacted, the focus was on the purchase of health insurance, life insurance, and disability insurance rather than on the reimbursement of money spent by people in particular ways. As I have said, our current policy reflects certain assumptions. We want to encourage spending in a specific way, and we assume that it is cost-effective to use the tax system to encourage this type of spending.

We sometimes talk as if getting one more person into a pension plan is good, no matter what the cost. I think we would agree, however, that this is not the case. We would not spend $1 million in order to get $1,000 of additional savings, particularly—this point was made earlier—if the specific provisions for tax benefits lead to a redistribution of the tax burden in ways that we would find unacceptable, or at least unacceptable in the absence of a belief that the redistribution had significantly changed the way people spend money.

The Value of Ceilings on Tax-Excluded Compensation

We can protect against too large a shift in the tax burden by imposing a ceiling of some kind. People have talked about a dollar ceiling, a percentage ceiling, or both, on the amount of compensation that can be excluded from tax or otherwise subject to favorable tax treatment. One purpose of a ceiling would be to prevent or to limit a shift in the tax burden.

A ceiling may be appropriate for other reasons, as was discussed earlier. The question is, at what levels of income do we want to provide preferential tax treatment—a subsidy—to encourage savings for retirement? Social Security does not replace wages all the way up to $50,000 or $60,000 a year. It is limited to a lower replacement amount.

Similarly, one could argue that when we provide a subsidy through the tax system, we should apply it to replace wages only up to a certain point. Above that point, people should be on their own. We often talk about ceilings of the section 415 type as having an impact not only on high-income people but also on the rank and file. I would certainly agree that we do not want the absence of cost-of-living adjustments to, in effect, make a $60,000 ceiling equivalent to a $5,000 ceiling at some point in the future because of inflation.

But people make two other points when they say that ceilings are going to affect rank-and-file workers. First they say, if an executive earns $1 million a year, a pension of $90,000 for that person amounts to a 9 percent pension, and he can adopt a 9 percent pension for his employees across-the-board, which obviously will reduce the benefits that people might otherwise expect to get if there were no section 415 ceiling.

We all know that there is a very simple way to prevent this situation from occurring. Namely, it is to impose a ceiling on the amount of compensation that can be taken into account. If the ceiling were $120,000 and you wanted to provide a $90,000 pension for yourself, you would have to provide every employee with the equivalent of 75 percent of their earnings. For top-heavy plans, 45 percent is required since $200,000 is the earnings ceiling for benefit calculation. I would say $200,000 is probably too high.

Of course, the argument may then be made that if an employer were to be required to give low-paid workers pensions of more than 9 percent in order to get $90,000 pensions for higher-paid workers, he will drop the plan because it offers too little tax benefit.

This brings us back to the issue that I discussed earlier, that is, how much are we willing to spend for an additional dollar of savings on behalf of low-income people? I have difficulty believing that lowering the section 415 limits is going to truly interfere with plans that are actually furthering retirement savings for low- and moderate-income people. If doctors drop their plans, it is not a loss for the overall pension system, even though the receptionist may have lost a retirement savings benefit of $10 or less per month.

It is questionable whether lowering the section 415 limits really will have an impact. If it were to have an impact, it is clear that we would need a very large carrot to induce high-income people to develop plans. In that case should we not be seeking a better way to provide retirement protection for low-income people?

So I think ceilings make sense in terms of: (1) preventing too large a shift in the tax burden; and (2) limiting our subsidy to the kinds of protection that public policy would suggest ought to be aided by public funds. In

addition, when we are talking not about wage replacement but rather about things like child care or medical reimbursement, which are not directly related to wages, we may worry whether a subsidy that is too high may encourage spending for what might be considered luxury care.

Objections to Reimbursement for Child Care and Some Other Expenses

When a benefit is not universally needed—compare, for example, child care with medical insurance—do we want to create a great difference in the tax burden between two individuals who would otherwise have the same income, because one spends a large portion of earnings for child care, and one does not?

In examining public policy with respect to child care, at least prior to enactment of the Economic Recovery Tax Act (ERTA), we find that there was a tax credit approach as opposed to a tax deduction approach. There was also a fairly low dollar limit on the amount of expenditure that could be subject to the credit; this approach clearly reflected a concern for the child care needs of low- and moderate-income people—rank-and-file workers—rather than an attempt to subsidize large expenditures for child care by the relatively wealthy.

A sharp shift in focus, as some interpretations and plans that have been adopted under the 1981 act indicate has occurred, should have been much more thoroughly discussed than was the case when these provisions were adopted in ERTA.

I believe that including reimbursement for child care expenses and perhaps medical expenses in a cafeteria plan is highly objectionable, if not abusive. Let me explain. Let's suppose an employee goes to the employer and says, "I know you owe me $200 in salary this week, but I don't want it, so don't pay me the salary. But, I do have a $200 bill for dental services that I've just paid, and I would like you to reimburse me for the cost of the dental services."

On the surface, we can say, nothing has happened. In either case, the employee has received $200 in cash. The only thing that seems to have changed is the tax burden, if the $200 reimbursement for dental care can be excluded from tax.

If we consider the purchase of life insurance or health insurance through a cafeteria plan, the same principle applies. If an employee is given the choice between $200 in cash or $200 of medical insurance, it looks as though nothing has changed but taxes. The employee has a $200 benefit in either case.

But something has changed if the incentive has worked, that is, if work-

ers have greater insurance coverage than they would have in the absence of a special tax provision. It is also possible that the incentive operated in the case of the dental bill. The tax exemption for that $200 reimbursement could have caused a person to go to the dentist. Similarly, some people may use child care that is more expensive than the care they would have purchased if they had to pay for it with before-tax dollars.

It is possible to look upon the reimbursement of these expenses in the same way that one would look upon the purchase of insurance, but I still view reimbursement as an abuse. In much of the publicity, people who are taking advantage of the system seem to think it is a terrific gimmick. The possibility that the incentive has a very small effect in these circumstances, at least on the initial users, may account for my view.

This contrasts with the purchase of insurance. People do not expect to get sick, to become disabled, or to die. Perhaps we need tax relief to encourage them to buy insurance, since everyone gets a terrific psychological kick out of a reduction in taxes.

On the other hand, when we are discussing a potential expenditure for a current need, it seems possible, at least, that what was intended as an incentive to encourage certain action becomes for most people just a tax reduction; their behavior is in no way changed. If I am right—and I do not know of any research that answers these questions—we have merely shifted the tax burden in the child care area away from high-income people who use expensive child care to people who do not. Even if the incentive works, there may be a problem. Since medical, life, and disability insurance are relatively universal needs, we can consider the special tax treatment as roughly equivalent to an across-the-board tax cut. With child care the tax relief is more limited and heavily tilted toward the well-off. As I stated before, it is quite clear that public policymakers did not openly decide to shift the tax burden.

I also do not understand how the concept of nondiscrimination can work with respect to cash reimbursement. Have these child care plans encouraged use of child care by people at both ends of the wage scale? Remember, we are seeking nondiscriminatory utilization, and in many cases, the tax credit is going to be sufficient and better than the tax exclusion for low-income people. They will not be interested in the exclusion.

How do we decide whether there has been nondiscriminatory use of child care? First, it seems unreasonable to take account of nonuse by people who do not need child care. Consider an example concerning medical care. The Committee report concerning the cafeteria provisions suggests that the purchase of a medical policy for a single person and for a family should be considered nondiscriminatory if the same type of policy

was purchased in both instances, even though the family policy cost much more.[1]

In other words, we look to similarly situated people to determine whether there is discriminatory use. But how do we decide which people are similarly situated with respect to reimbursement for dental care, for example? Are all people similarly situated, or are all people with toothaches similarly situated? Are all people who go to the dentist—regardless of the cost of the dentistry—similarly situated? Or are all people similarly situated, who go to dentists charging $200 as opposed to dentists charging $50?

If the incentive is designed to encourage people to obtain care for their aching teeth, the right group is all the people with toothaches. But how do we know who they are? Similarly, the purpose of the child care deduction is to provide an incentive for more women to be able to enter the work force. The group affected includes all people with children under a certain age, regardless of whether there is a nonwage-earning spouse at home. If the incentive is designed to encourage people to have children, then the group could be all people of a certain age, regardless of whether they have children or not. If you do not adopt this kind of approach but instead look only to people who actually incur child care expenses, it is difficult to find discrimination, because one employee spends $100 while another spends $200.

In other words, if it is not discriminatory to give employee A $200 a week for child care and employee B nothing because employee B does not use child care, it is hard to argue that it becomes discriminatory when employee B incurs costs of $10 a week for baby-sitting while employee A incurs $200.

If we approach the problem this way—we look only to the people who incur the expenses—the incentive automatically becomes nondiscriminatory. In any event, I think there is enough leeway in possible interpretations of the law to allow "nondiscriminatory child care plans" to be easily adopted by some people with large cash reimbursements, and with little incentive effect and big shifts in the tax burden.

I conclude that this policy is not sensible; I believe that Congress should make clear that this outcome is not what it intended. I do not think that we should necessarily rule out the continued acceptance of flexible compensation plans that provide special tax benefits, but I think that, to ensure the survival of good plans, we should speak out against the bad ones—those that will give a bad name to all of them.

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[1]Editor's note: The reference is to the House Ways and Means Committee report (H. Rep. No. 95-1445 to accompany H.R. 13511, 95 Cong., 2nd sess., August 4, 1978) on proposed legislation which subsequently became the Revenue Act of 1978 (P.L. 95-600).

Discussion

Premiums versus Reimbursements

MR. ALLEN: Dan Halperin made a distinction between premiums and reimbursements. If you were to ask the employers in this room to define their insurance premium, they will answer that it is what they paid out in claims plus expenses. In the real world of employee benefit plans, we are dealing with reimbursement as the premium. In many ways in the groups we are involved with, they are equivalent.

MR. HALPERIN: Not from the employees' point of view. From the employees' point of view, that's insurance, because they pay for it whether they use it or not. That is a premium, from my point of view.

MR. ALLEN: I think that our actuaries are skillful enough to work out a cost for vision care plans that will come quite close to the premium being paid as a benefit.

MR. HALPERIN: Will you come out with a vision care plan that affects the salaries only of people with eye problems?

MR. ALLEN: When you want the coverage, the insurance premium is X dollars, and X dollars is going to come remarkably close to the cost of getting an ophthalmological examination plus eyeglasses. I think I could probably come pretty close to figuring out the cost of covering a deductible or coinsurance, although coinsurance would be more difficult.

But, I could produce an "insurance premium" that is basically the reimbursement concept. I think you will have difficulty developing a notion that premiums are okay and reimbursements are not.

In Defense of Cafeteria Plans

MR. HUTCHINGS: I think we should be careful to consider cafeteria plans as a whole rather than looking at the individual benefits one at a time. It also bothers me to hear child care for the wealthy confused with health care.

I agree, however, that it is very hard to apply a use test for nondiscrimination in an area like health benefits. Utilization is going to be a function not only of the choices that individuals make about their coverage, but also of their health status, the practitioners who provide the care, and so on. I think that the utilization approach is much less sensible than the availability approach.

I do not think we ought to say that cafeteria plans were designed to give further incentive for expansion of insured programs. I think these plans were designed to permit a more neutral stance, so that an employer who had more health insurance than perhaps the circumstances warranted could substitute a multiple-option plan and let the employees reallocate the difference in cost. In other words, the tax incentive for the health benefit was there long before section 125 was enacted.

The Purpose of the Child Care Benefit

I think that the child care question has been discussed as if we were talking about child care for any purpose. In fact, however, we are talking about child care specifically for the purpose of enabling gainful employment, and progress against the objective, it seems to me, is going to be measured by the extent to which people can afford to have the second spouse go to work.

My wife and I looked at this question in our home. After netting all the numbers, my wife would have lost $1,000 a year if she had gone back to work as a computer programmer. In 1983, especially in the presence of the well-thought-out cafeteria plan, that minus $1,000 figure would be a respectable plus. We are trying to make it feasible for both spouses in a family to work.

But, to return to health benefits for a moment, I think that the inherent tax subsidy that has been present for health benefits is not confined to the cafeteria plan aspect and has to be looked at more broadly.

Establishing Ceilings

MR. SCHIEBER: I take it from Dan Halperin's comments that he thinks the section 415 ceilings should somehow be maintained on a real basis over time, and the $90,000 ceiling is too high.

By what formula do we arrive at reasonable ceilings? There are various ways of determining what this level should be. One of them is purely political. An alternative may be some empirical approach, but I do not know what that is. Last year Congress thought that the ceilings were too high and decided to reduce them. Then Congress decided to freeze them for a while. Now they may be frozen for a bit longer. Freezing them implies not only that you have decided the ceilings are too high, but also that you have decided that you are going to reduce them to a level that you still think is too high.

How do we determine a reasonable level?

MR. HALPERIN: Obviously, that is a political judgment in some sense. How do you determine the amount of wages to cover under the Social Security Act? Political judgments are a mixture of equity and self-interest, but one can hope that further discussion, further enlightenment, and further involvement of employees who understand that their tax burden is higher than it would be if these limits were lower would lead to the "political" judgment as to what is a fair subsidy and what is essential in order to get the most bang for the buck from the incentive.

I think the section 415 limits are too high, but that may be a personal judgment. I would not claim to be able to demonstrate that by a matter of logic, just as I could not demonstrate quantitatively what the maximum Social Security wage base ought to be.

I also want to comment on a point that was made earlier. It is possible that we could decide that encouraging more two-earner families in our society is good public policy. Allowing a full deduction for the cost of child care would help achieve the established objective. One can argue about whether this policy is sound or not, but if we want to achieve this objective, we do not need to use cafeteria plans to do it. We ought to state our goal directly and get rid of the hocus-pocus. If we use the cafeteria plan, we are making the judgment that the objective is sound policy only if it happens on a "nondiscriminatory" level. Yet I think a tax credit is a better way of getting that result in view of all the problems in figuring out what nondiscrimination for a child care benefit is.

MR. ALLEN: Under Internal Revenue Service (IRS) practice actuaries are not permitted to take into account potential growth in the section 415 limits in developing the funding levels of a plan. This restriction is inconsistent with the fundamental requirement that actuaries are supposed to use assumptions that in the aggregate are a best estimate of a plan's true liabilities.

This results in reduced funding of plans. Is it consistent with the overall goal of achieving adequate funding levels?

MR. COHEN: The Tax Equity and Fiscal Responsibility Act (TEFRA) basically codified the IRS position that existed with reference to section 415. That position was based on the premise that the cost-of-living adjustment was designed to keep the section 415 dollar limits resistant to inflation. However, the question is, should a plan sponsor receive an increased deduction now for funding these benefits?

There is a big difference between the available minimum and maximum funding requirements. Plans that are funding at the maximum and adjust the funding each year are not experiencing problems with funding.

The law gives actuaries a tremendous amount of responsibility in making estimates, but that does not mean that actuaries can make their estimates on whatever basis they choose.

The Potential Effects of Changes in the Tax Treatment of Employers' Health Insurance Contributions

Paul B. Ginsburg

The health insurance area of employee benefits tax policy is unusual in that the entire impetus for changing the tax treatment has come not from tax experts but from health care reformers. Many of the people who have worked the hardest to impose a limitation on the tax exclusion of health insurance contributions have done so because of the effects they envision on the health care system.

Basically, people in the health care field who want to limit the tax exclusion are the market-oriented school of health policy experts. In essence, they would like to make greater use of market forces in health care, and they see the existing tax treatment as contributing to difficulties in that respect.

Basically, their argument is as follows: the subsidy to employees who shift compensation from wages to health care is on the order of 38 percent (the estimate of the average marginal tax rate of employees who receive health insurance contributions from employers). This has given people an incentive to change the way they finance health care from out-of-pocket financing to a greater use of health insurance. In turn, this more extensive use of health insurance has led to a high use of medical care. Not only have the rates of patient visits and hospital admissions risen, but also care has become more resource- or service-intensive.

Reduced Comprehensiveness of Employer-Paid Health Insurance

There is little literature on the effects of price on the purchase of health insurance (by "price" I mean not the premium but the loading charge—the difference between the premium and the expected benefits or reimbursements). Nevertheless, the existing literature indicates that group purchase of health insurance is somewhat sensitive to price. Hence, it seems likely that changing the tax treatment of health insurance contributions would significantly affect the comprehensiveness of employer-paid health insurance.

Increased Cost Sharing

I think the principal effect during the first few years after a change in the tax treatment of health insurance contributions would be in the form of increased cost sharing. Policies would have larger deductibles and higher coinsurance rates. They might drop some services, such as eye care or dental care, that are included in some policies today.

Effect on the Use of HMOs

Some people believe that a change in the tax treatment of health insurance contributions would be an inducement to people to use health maintenance organizations (HMOs). These prepaid health plans have been quite successful in lowering costs. But I am quite skeptical that a change in tax treatment would encourage people to use HMOs. Health maintenance organizations, at least as we know them today, are associated with relatively comprehensive health insurance coverage. Thus a change in the tax treatment of health insurance to encourage less comprehensive health insurance would not necessarily encourage use of health maintenance organizations.

Encouragement of Innovations in Health Care Delivery

There has been much discussion of innovations in the private sector, such as preferred-provider organizations and primary care networks, to contain health care costs. A number of innovations in the corporate purchase of health benefits also are being talked about. There is little evidence of innovation—let alone evidence of success or failure. Still, many people argue that a tax limit on health insurance would increase use of alternative health care financing.

Certainly a change in the tax treatment could theoretically make a large difference, but whether it would remains open to speculation. We do not know how close HMOs are to economic viability. If they are close to it, placing a tax cap on health insurance premiums, at least for the marginal dollars of health insurance, would probably make them grow very rapidly. Conversely, if they are very far from economic viability, a change in tax treatment would not make much difference.

Estimated Price Effect of Health Care Tax Exclusion

I have made some calculations of the impact of a health care tax exclusion limit at about the level that the President has proposed, and I think

my estimate is conservative. I find that after about a five-year period with a cap at this level, people who receive employer-paid health insurance would have reduced their health spending by about 9 percent. Most of this reduction would come from reduced use of services; a small proportion would represent reduction of medical care prices compared with what they would otherwise have been.

Some people may find the price effect disappointing. One reason for such a small price effect is that employer-paid health insurance, even though it is very important, still represents a minority of total health care financing today. The major portion is made up of the Medicare program, which is particularly large when it comes to hospitals, plus Medicaid, plus some individually purchased health insurance that would not be affected. So the price effect would tend to be diluted because of the absence of a similar change in the policies of the other payers for health services.

I called this estimate conservative because it was based just on the effects of cost sharing on health care use and prices, without assuming—and this reflects my skepticism—that there would be any major effects from changes in preferred-provider organizations.

Potential Revenue Effects

Even though changing people's use of health care is the main focus of the tax cap proposal, certainly the revenue effects are important—the current revenue loss attributable to health insurance is about $26 billion a year. Many political observers have said that if a provision like the one we are considering is enacted, it will be because of the potential revenue gains.

Much attention has focused recently on these potential revenue gains. The Congressional Budget Office (CBO) and the administration have both published estimates showing fairly significant revenue gains as a result of a tax cap. If the tax exclusion is limited, revenue can be gained in one of two ways: (1) if behavior does not change, people will pay more tax; and (2) employers would shift compensation away from health insurance towards cash, which would raise revenue through taxation of the increased wages.

Some of the opponents of the tax cap proposal have suggested that the revenue effect would be small because employers might well shift their excess health insurance contributions into other nontaxable fringes, such as pensions. However, I doubt that they would to any considerable extent. I would be very surprised if a large portion of excess health insurance contributions wound up as additional pension contributions or as any other nontaxable fringe benefit.

I reason that people are already making portfolio decisions about where to put compensation and health insurance, cash, and other nonhealth, nontaxable fringes. Essentially, we have already reached an optimum allocation of funds between cash and the other nontaxable fringes. I do not think that taxation of a small amount of health insurance would change the optimum allocation between cash and the other nontaxable fringes. To the extent that there was a shift in compensation, I would expect to see cash and other nontaxable fringes getting about the same proportion of the excess health contributions that they do of total compensation today.

Uneven Effects on Individuals

Another issue is the effect on different individuals. A tax cap would have very uneven effects. Because people get very unequal contributions today, they have different marginal tax rates, and their benefits are very uneven.

Some of the unevenness may be politically attractive. The CBO has developed figures showing the impact of the tax cap on different income groups. Employees in the upper-middle- and high-income brackets would bear a large portion of the tax increases, or at least they would pay proportionately more, because they are more likely to have health insurance. When they have health insurance, not only do they have richer plans, but also they are in higher tax brackets. Some policymakers have found the progressive nature of the option attractive.

Uneven Regional Effects

The uneven regional effects of a flat tax cap may pose a greater problem. It has been pointed out that for a given health insurance policy people in Los Angeles pay twice as much as people in Raleigh, North Carolina; regional differences in medical care costs and practices mean that the variation in insurance premiums often reflects not the richness of the policies, but local medical care conditions.

Some people have advocated actually varying the tax limit by region, but others object that such a step would be unprecedented for the tax code, which so far has resisted variations. Probably we should assume a uniform tax cap, looking at any inequities as a fixed liability rather than a removable one.

Summary

Thus far, most of the debate over the tax exclusion of employer health insurance contributions has focused on the likely effects on the health

care system of proposals to limit the tax exclusion. I think that any limit would significantly affect the health care system, but many people would be disappointed that the impact was small in comparison with the problem of rising health care costs. Revenues would be raised, but the burden would be unevenly distributed.

Discussion

MR. SALISBURY: You mentioned a 38 percent subsidy. Do you believe that the average marginal tax rate of people receiving health insurance coverage is 38 percent?

MR. GINSBURG: That includes both shares of the Social Security tax.

MR. SCHIEBER: Are you saying the marginal income tax rate must be 25 percent and the payroll tax would be another 13 percent?

MR. GINSBURG: Something like that. I think the effective marginal tax rate is a little higher than that, and the payroll tax is a little lower.

MR. SALISBURY: The Social Security Administration's long-term cost projections assume significant ongoing reallocation of the cash and noncash compensation relationship. The roughly $50 billion that went into individual retirement accounts last year also implies a certain continued interest in noncash compensation. The movement toward section 401(k) and cafeteria programs is further evidence that we have not yet reached the optimum balance of cash and noncash compensation. If you were to change your assumption and assume that there would be a 100 percent shift to other benefits, how much revenue would you gain?

MR. GINSBURG: Clearly, with a 100 percent shift, there would be no revenue gain. It is important to remember that the optimum balance between cash and noncash compensation is changing. When we talk about the revenue effects of a proposal like this, we mean the revenues received as compared with what revenues would have been received in the absence of such a proposal. Work force age differences will tend to be diluted because we are talking about company averages. The differences in the average age across firms will be the issue; that is why I think regional variations might be more dramatic. They are undiluted, except in multi-state firms.

The other issue depends on your perspective. Since older people use more health care than younger people, older people get a much larger tax benefit today. In a sense, the tax benefits would be evened out by a limit on the tax exclusion, so the people getting the greatest benefits would also be hurt the most by this change. Some people might consider that result acceptable, while others might view it as a major problem.

MR. HIRSCHLAND: Worker age is important. The work force in some industries is older than the work force in other industries. For example, at

the Xerox Corporation, the average age of the workers is thirty to thirty-five, as opposed to the average age at Chrysler, which is probably forty-five or fifty. The difference is staggering.

MS. CHOLLET: I want to agree with Paul Ginsburg that it is unfortunate that the proposals to tax employer contributions to insurance have come from promarket health economists as opposed to tax specialists. They, and you, admit that the relationship between employer contributions to health insurance and reduced prices in the use of health care is somewhat tenuous. People have the ability to change their coverage even within their health insurance package, and most people probably would elect higher hospital coverage rather than dental care. In fact, hospital coverage is the driving force behind the inflation in health care costs. So many arguments can be raised about the effectiveness of tax policy changes in controlling health care costs.

Regressive Effect of Tax on Health Care Benefits

I would like to take issue—on the basis of research that EBRI has just completed—of your depiction of employer contributions to health insurance as somehow favoring high-income employees. Numbers from the Congressional Budget Office, in fact, indicate that there is no significant correlation between income and employer contributions to health insurance among the population.

Therefore, among households affected by a tax on employer contributions to health insurance, the incidence of the tax is severely regressive, because lower-income persons tend to have a work force participation pattern that is more fragmented than the pattern of other people. But the fact that lower-income people less often receive employer contributions to health insurance than other people does not significantly improve the progressivity of a tax on employer contributions to health insurance.

Fragility of Revenue Estimates

A second issue that has been raised here relates to the fact that these estimates of revenue are fragile because, in fact, managers of employee benefits are quite clever at protecting the interests of employees—which the employees certainly encourage. The estimates are also fragile because of assumptions about the rate of employer contributions to health insurance, the possible changes over time, and the likelihood that they would

be constant in real terms or money terms. They're fragile because of the assumption that there would be constant coverage rates.

Effects of Tax on Rates of Coverage

As a result, the rates of coverage, particularly in lower-income households, would drop. A simulation performed by EBRI assuming that all employer contributions to health insurance would be taxed as income to the employee—therefore making the employee indifferent between health insurance benefits and cash income, and the employer indifferent between the provision of health insurance and the provision of cash income—indicates that less than half the households of workers earning less than $15,000 per year (in 1979 dollars) would have health insurance in the presence of a tax cap. This indicates that there would be a strong coverage response among the employee population and their families as well.

I do not think this issue has been adequately addressed either by the tax policy community or by health economists. So I have two questions for Mr. Ginsburg. The first has to do with public insurance programs versus private insurance programs. Inflation in public insurance programs, particularly in Medicaid and Medicare, has outweighed inflation in privately insured spending for hospital care in particular. Medicare does have a deductible on hospital care and may in fact institute a copayment, but Medicaid has established a standard of comprehensive health insurance coverage. Are we now saying that comprehensive health insurance is acceptable for the Medicaid population?

Secondly, the debate about taxing employer contributions to health insurance seems to be boiling down to one of tax progressivity and, as in this case, tax regressivity. How do you expect this issue will be handled?

Medicaid's Approach to Containing Costs

MR. GINSBURG: On the point about Medicaid, I am not sure that the evidence is correct—that hospital reimbursements on a per capita basis have been rising more rapidly in public insurance than in private insurance. Until recently, most payers reimbursed costs, so I do not see why there should be any difference once you have made all the necessary adjustments in the data. This is what has happened: Medicaid has not gone to hospital cost sharing, but instead, on a state-by-state basis—because the federal government has decided that Medicaid is really a state program

and that states ought to act on their own initiatives—Medicaid has instituted competitive bidding in purchasing hospital care. This has been done in California, for example. Medicaid is thus not ignoring the problem of hospital costs, but it has chosen a method other than cost sharing to help solve that problem.

I want to emphasize, however, that I believe that cost sharing will be the major mechanism through which adjustments in health care insurance will be made. Many government officials do not like cost sharing. Maybe a good subject for discussion would be whether cost sharing is desirable or whether something else will develop.

As for your research on the progressivity or regressivity of a tax cap provision, I do not know what to say. I thought that the CBO results were fairly clear—that as income went up the additional revenues from a tax cap would be higher. Otherwise, I cannot comment on your research.

Limiting versus Eliminating the Tax Exclusion

The final issue concerning coverage is that there is a big difference between limiting the tax exclusion and eliminating that exclusion altogether. In a sense, there is something surgical about a tax limit. It says that we want to keep the tax incentives for health insurance, but we do not want people to have an unlimited amount tax free.

It is difficult to see how a tax limit, unless it was set very low, would affect the decisions on coverage, because the limit only affects firms with contributions over that limit.

Potential Change in the Use of HMOs

MR. SALISBURY: Let me offer one hypothetical example, since I am curious about your comment that some people suggest that a tax exclusion would increase utilization of HMOs.

In the Washington, D.C., area, for small employer groups, the available HMO options cost 20 percent more for both individual and family coverage than does insurance coverage from Blue Cross/Blue Shield. So I can provide my employees with coverage from Blue Cross/Blue Shield below the tax cap currently being suggested, whereas they would incur a tax for participating in the HMO.

Now if a cap were imposed, I assume that the 70 percent of my employees who have now taken the HMO option would instantly drop the HMO and move to Blue Cross/Blue Shield. The IRS would gain nothing. The only

thing that would really be helped would be my budget, because it would cost me less to provide health coverage; but tax revenues would not be affected.

Now, theoretically, this reasoning applies to the situation of almost everybody in this geographic area, and I assume that the same thing must also apply in other areas of the country, so there is a problem with the assumption that use of HMOs would increase.

MR. GINSBURG: This is the basis of my skepticism about a major HMO effect; there are many areas like Washington where the HMOs have higher premiums. The net, bottom-line cost to a subscriber of an HMO could nevertheless be lower, because one reason why HMOs have higher premiums is that they offer more comprehensive coverage. That is what I mean by this wedding of very comprehensive coverage to the HMO.

Conversely, there are areas of California, for example, where HMO premiums are significantly lower than those of the Blue Cross and other standard plans, and in those areas a tax cap would certainly tend to increase the use of HMOs. But I agree with you basically—which is why I do not cite the increased use of HMOs as a likely effect of a tax cap.

The Progressivity/Regressivity Argument

MR. SALISBURY: Also, on the progressivity and regressivity of the tax cap, there are two ways to look at the CBO numbers. One way is to look at them from the perspective of whether the relative percentage paid in tax is higher at the higher-income level, and from that standpoint, the effect is progressive. If you look at the numbers in terms of the amount of additional tax being paid as a percentage of the individual's total current tax payments, the effect is very regressive; from that standpoint, the provision does more damage to individuals with lower income. I think the CBO numbers indicate that the tax cap provision would be more damaging to the purchasing power of low-income persons than to the purchasing power of high-income persons. I would have to view that effect as regressive, not progressive, but I hear you defining it as progressive.

MR. GINSBURG: It is unfortunate that there are a number of different definitions of progressivity floating around; in part, it depends on whether you are talking about low-income or high-income people. In other words, the relationship between the amount of tax paid and income is not linear. People earning $50,000 to $100,000 a year would be hit the hardest. Above that income level, people have much more self-insurance, so people at the highest income levels would not be hurt as badly.

MR. SALISBURY: But for persons earning $50,000 to $100,000, the numbers show that the effect of the additional tax would be insignificant as a percentage of disposable income compared with the effect on people who make $10,000 a year and are subjected to tax on the same amount as a percentage of their disposable income.

MR. GINSBURG: Yes, this is an issue of averages versus individuals. Most low-income persons would not be affected at all, so you have a lot of zeros being averaged in with, say, the figure for the janitor at IBM, who was heavily taxed.

The Question of Discrimination

MR. ALLEN: It is interesting to listen to a discussion of medical costs. We all agree that the cost and use of medical care increase with age. Notwithstanding, is the fact that the Equal Employment Opportunity Commission has chosen to say that medical costs do not vary by age and that any attempt to vary benefits or costs by age constitutes a discriminatory act.

MR. FLEMING: I am associated with the Bakery and Confectionary Workers Health Benefits Fund, and I want to give some practical applications of what you are proposing and how it would affect a baker who is obviously neither well-to-do, nor indigent.

We have a fairly sound health benefits program that provides for all the basic health care needs. There is nothing exotic about our program, unless you consider eyeglasses and prescriptions exotic.

Under the administration's proposal, bakers in Chicago would begin paying taxes on their benefit program immediately, whereas bakers in Little Rock would have some distance to go before they had to start paying taxes on their benefits. The bakers in both places are covered by the very same plan of benefits, and they are doing the very same work, but the anomaly would exist. Simply because a person resides in Chicago, he would pay a federal tax that the resident of Little Rock would avoid.

I also want to compare a baker in Chicago with a well-to-do professional in Chicago. As I said, the baker in Chicago is covered for the basic health care benefits, mostly in hospitalization, and the professional is assumed to buy the same amount of coverage. Both would pay exactly the same rate. Mr. Ginsburg indicated that the tax burden would fall on people who were better able to afford it. I disagree, because if you buy Blue Cross/Blue Shield in Chicago, you pay the same rate whether you happen to be a wealthy attorney or a baker. The basic cost for a day of hospitalization is fixed. So the tax burden would not fall just on the well-to-do, but rather it

would fall across-the-board, and, consequently, would be as much of a burden to people who were less able to afford it.

I agree with what some of the employers have said today: if this cap is imposed, the net result will not be additional revenue, but rather a lessening of health care for the people. I do not believe that a lessening of health care can be considered a legitimate goal of public policy.

The Relationship Between a Tax Cap on Health Benefits and Other Policy Goals

MS. YOUNG: I want to ask if anyone has attempted to integrate this proposal for a tax cap with other public policy goals? For instance, legislation requiring pregnancy coverage in health plans has been enacted. Insurance company actuaries said the costs would be high; presumably those costs are being paid. If a flat cap is imposed, will we find ourselves arguing once again over whether it is fair to mandate pregnancy coverage, and then find that people drop that coverage in order to get under the cap? Is the cap proposal fair if an older group is involved? Has anyone even considered the matter of a cap in terms of these issues, and in terms of other benefits that could be provided, in view of what the employers and the unions are saying?

Is it not possible that a tax cap on health benefits would just build pressure for new kinds of nonhealth-related employee benefits? How nice it would be if one could get around some of the discrimination issues now being debated in Congress by having group auto insurance provided by employers. I am sure somebody is thinking about this.

MR. GINSBURG: It is difficult to answer that question, because the people who have advocated a cap on health care benefits have spelled out the behavior that they hope ensues, and they have not addressed these other matters.

MR. SALISBURY: Leah Young is a reporter for the *Journal of Commerce*, which makes her question particularly interesting. I want to ask Paul Ginsburg if the CBO has factored the issues she raised into its analysis and the analysis that led to the CBO assumptions.

MR. GINSBURG: The one relevant thing from our analysis is the assumption about the types of changes in the benefit package that would occur, as Deborah Chollet mentioned. The analysis assumes that hospital care probably would be left alone, and that the reductions in coverage would focus on outpatient care, dental care, eye care, and the like.

We based this assumption on what insurance is most valuable to people.

MS. YOUNG: Did anyone factor in the pregnancy argument?

MR. GINSBURG: If a regulation is going to make health insurance more expensive by requiring coverage of something that has not previously been covered, an employer over time will pay the bills by slowing down wage increases or cutting something else in the benefits package.

MS. YOUNG: But doesn't it work the opposite way? For example, the law has mandated that something be covered, in this case, pregnancy. Then if the government says that employers must cut their benefits or pay taxes, then isn't the whole discrimination argument likely to be reopened?

MR. GINSBURG: I think you are raising a political argument. In other words, the pressure is on the political process. I am always uneasy commenting on political arguments because of my position. I do not want to anticipate what Congress might do. So I would like to leave it at that.

MS. YOUNG: I take it there have been no studies as to what new benefits might be demanded or what pressures might be raised? You just assume they are not going to happen?

MR. GINSBURG: We just have not looked into the political pressure for changes in other laws that might result from tax limitation.

MR. SALISBURY: Let me ask the question in a different way. I think what Ms. Young is saying is that you are still assuming that there will be no change in employers' behavior toward the insurance company, which is how you reached your estimate of significant revenue gain.

What she is suggesting is that employers will automatically look for another place to put whatever money is "saved" by the imposition of a cap—whether they put the money into current benefits or into new benefits—in order to keep from giving you the tax revenue you are looking for and to make sure the employee continues to receive the same total compensation.

MR. GINSBURG: I did not know that is what she was saying. We have gone through that argument a number of times today. Employers have commented, looking into next year, that they would like to put the money into other benefits. I am talking about how things will be, not compared with this year, but compared with how they would have been next year in the absence of any legislative change.

In other words, money is moving into pensions anyway. Are employers going to move into pensions a lot faster, because of this limitation on health insurance?

MS. YOUNG: What I was asking, in essence, is this: even if we accept your assumption that employers will not move faster into pensions because

they are already moving that way, why are they precluded from moving into something other than pensions? There are all kinds of options available.

MR. GINSBURG: In other words, you are saying employers will lobby to put more benefits into the tax-free category.

MR. SALISBURY: They do not have to lobby. The options already exist.

MR. STRATTON: To some degree this is the direction in which we would like to go. Health care costs have been rising so dramatically that our ability to liberalize other benefits that need liberalizing has been limited. Therefore, if the government limits the amount of money that can go tax free into health care benefits, employers just find it easier to move those same dollars into other benefit areas.

MR. GINSBURG: I guess I plan with a little longer time horizon than business managers do. It seems to me that economists and business managers have been arguing like this for decades. We have studies that indicate there is some truth in what we say, but I do not know if the question can really be resolved.

The Inability of the Tax System to Solve Inflation in Health Care Costs

MR. HIRSCHLAND: I do not believe we can solve the problem of inflation in health care costs through the tax system; instead we have to examine the way the health care system works. The cost of health care is a problem for employers and employees regardless of whether a tax cap is imposed. The cost saving programs Paul Ginsburg mentioned as evolving in California, for example, have evolved despite the fact that there is no tax cap.

Many employers are already saying that they cannot afford to continue to provide the broad health care they now provide—and that is their position before any changes are made in the tax system.

The true effect of imposing a tax cap really is to make the individual employees and their families the focus of cost containment. "You, the employees, are going to have to make decisions about whether you need certain care, whether you need to be hospitalized, and we are going to let you be the persons to make the assessment." The employees are probably the persons least able to make those judgments. They just cannot do it. They do not make those judgments now; their physicians tell them they need to be hospitalized or need certain care, and the employees are not in a position to argue with their physicians. In order to address the problem of inflation in health care costs, we must address the system and how care

is provided. We must change the methods of reimbursing doctors, and we must put some controls on new building, on new equipment, and on other things that cause hospital costs to escalate. Individual employees cannot do these things.

The savings that might be generated through imposition of a tax cap do not approach the magnitude of the inflation problem. If the government wants to consider raising additional revenues, and you say this is an equitable way of raising additional revenues, that's one issue. I do not want to address that issue now. If, however, you want to talk about the problem of inflation in health care costs, which is a problem not just for private insurance programs, but for Medicare, Medicaid, and people who have no insurance at all, imposing a cap is not the way to solve that problem, and it is a problem that needs to be solved.

MR. GINSBURG: Your comments are very much on target. As I mentioned at the beginning, the tax cap proposal is the proposal of the market-oriented health care reformers who want to put the responsibility on individuals or at least indirectly on the physicians who act as agents for individuals.

If you are uncomfortable with the market approach and prefer regulations such as hospital rate setting and reform in physician reimbursements—although we have not found the ideal answer to reimbursement yet—then imposing a cap would not be the policy of choice.

Preferred-Provider Organizations

MR. HIRSCHLAND: Using preferred-provider organizations is one type of physician reimbursement reform.

MR. GINSBURG: Would you agree that preferred-provider organizations would be pursued much more vigorously if a tax limit were imposed?

MR. HIRSCHLAND: Major companies are pursuing them vigorously right now, because we have a serious problem with health care costs; our action does not relate to whether there is going to be a tax cap.

Our problem is this: we are spending more than $2,000 a year for family health care coverage, and much more than that for broad family coverage. That money is coming out of people's wages, and the health care it buys is delivered by a very inefficient system.

A hospital can generate its own living. Beds have to be filled, and doctors have incentives to provide services. We are pursuing solutions to our cost problems though we expect and hope that the tax cap will not be enacted.

Taxing Medicare Benefits

MR. KEENE: In the area of medical cost containment, I wonder if we are aiming at the proper target. The major problems seem to stem from the 1960s when Medicare was enacted. I am not necessarily advocating severe reductions in Medicare benefits, but Social Security itself is the social contract between workers and retirees. In recent years there has been much talk of distortion in that contract because workers are being asked to bear too much of the burden to support the retirees in Social Security.

If a health tax cap were imposed, another distortion would develop between the workers and retirees. Maybe the solution is to get the kind of "equity" that has just been enacted in the Social Security Act in the last go-round—that is, to think about taxing some of the Medicare benefits for the higher-paid people. That might be a logical next step.

Summary Comments by Members of the Panel

MR. ALLEN: I think it is critical, as we formulate policy, that we take into account not just the tax law, but other laws that affect benefits as well—that we really understand the ripple effects when we pass legislation. I am particularly concerned about the fact that through a whole series of different legislative pieces, directly and indirectly, we have focused too much attention on defined contribution plans, and we need to know the implications of our action.

MR. HALPERIN: I think all of us would agree that the pressure to raise new revenue and to limit government expenditures will continue. Whether we view tax benefits to pension and other employee plans as government subsidies or just as failure to collect taxes, the benefits are vulnerable under this kind of government effort. As a result we have to expect continued investigation of their cost-effectiveness. It will be necessary to try to separate the benefits that are cost-effective from those that are not.

I believe that if the business community is going to have an effective voice in the continuing legislative effort, members of that community must be willing to listen to the views of other people and take them into account as they formulate and respond to proposals.

MR. MELTON: To respond to the issue of the appropriate future tax treatment for employee benefits, I think I will play the academic and say I would like to wait for the results of the EBRI studies to show us where things are and what some of the attitudes are.

I certainly believe that it is appropriate to provide retirement benefits and, to take the pressure off of the Social Security system, these benefits must be provided to low- and moderate-income persons. I think that many of the concerns raised by employers and by unions about a cap on health insurance apply equally in the retirement savings area. The concern over the difficulty and complexity of plan administration is legitimate. I would like to see a movement towards actually providing retirement benefits in a less complex fashion.

MR. SMITH: I hope that all of us—unions, management, and government—can work together with open minds. If changes are to be made to cure abuses, let's make those changes with a rifle approach, not a shotgun approach.

EBRI is producing sound data and reaching sound conclusions, so that public policy no longer needs to be formulated in a data vacuum. It can be formulated in the real world to meet the needs of unions, management, and all of us.

MR. SALISBURY: I take two points from our discussions. It seems clear, particularly when we reflect on Paul Ginsburg's comments and the questions that Leah Young asked, that too frequently we focus on little pieces of a problem. We tend to think that we can change policy in just one piece of the entire realm of employee benefits without consequences in other areas.

As we look at the calculation of "tax expenditures" or "tax subsidies," I think one of the crucial assumptions is that behavior will in no way be changed if the law is changed. Yet if we know one thing from watching the development of tax law in all areas, it is that although there may appear to be no "loophole" today, we can bet that the lawyers will find one for us tomorrow or the day after. Experience has shown that to the degree that one change is made in the hope that it will have some tremendous effect, alternatives are consistently found.

In evaluating tax policy towards pensions, cafeteria plans, health benefit caps, or any other benefits, we need to consider all of them together and recognize that they, along with Medicare, Medicaid, Social Security, and other social programs, are an integrated whole. If we want to control the cost of health care or of other programs, we are going to have to start looking at these items as a whole, both corporately and in a public policy context.

In the realm of tax caps and other policies, planners should not base their assumptions of revenue gains on the belief that behavior will not change. Remember the instructive experience this past year with individual retirement accounts (IRAs). Somebody in the basement of the Treasury Department who does the revenue numbers must have been convinced that few people would open an IRA in response to the Economic Recovery Tax Act (ERTA). In 1981, therefore, it was estimated the ERTA change would amount to $1.6 billion in revenue losses in 1982-1983. In fact, as the IRA window was opened to tax-free haven, IRA deposits approached $50 billion, and the Treasury now estimates the 1982-1983 revenue loss at $18 billion.

That raises an issue that was mentioned in passing today: if we want to control the loss of revenue, should we just say, "This is a maximum percent of compensation that any employer can spend on benefits" and let the market do the allocation? This issue is beginning to be discussed on Capitol Hill.

On the one hand, the benefits community wants to encourage this discussion because policymakers should take everything into consideration; on the other hand, the approach might create huge problems of its own. In any case, today's comprehensive discussion offers hope for the development of more rational tax policy towards employee benefits.

Appendix A
Forum Participants

Moderator

Dallas Salisbury
Employee Benefit Research Institute

Speakers

Everett T. Allen, Jr.
Towers, Perrin, Forster & Crosby, Inc., and
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Thomas Ault
Department of Health and Human Services

John Baitsell
Mobil Oil Corporation

Paul Berger
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Phyllis Borzi
House Subcommittee on Labor-Management Relations

Stuart Brahs
American Council of Life Insurance

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Massachusetts Mutual Life Insurance Company

F. Patricia Callahan
National Association of Manufacturers

Elliot Carlson
American Association of Retired Persons

Yuan Chang
The Travelers Insurance Companies

Joel Chernoff
Pensions & Investment Age

Timothy Clark
National Journal

Ira Cohen
Internal Revenue Service

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Bankers Trust Company

Edward Davey
Association of Private Pension and Welfare Plans

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United Steelworkers of America

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Michael Hoon
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Eileen Peterson
Social Security Administration

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Central Bank of the South

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Blue Cross and Blue Shield Association

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New England Mutual Life Insurance Company

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Appendix B
A Selected Chronology of Legislation Dealing with the Tax Treatment of Employee Benefits

Pension Legislation

Revenue Act of 1921	Exempted interest income on trusts for stock bonus or profit-sharing plans from current taxation. Trust income was taxed as it was distributed to employees only to the extent that it exceeded employees' own contributions; did not authorize deductions for past service contributions.
Revenue Act of 1926	Income of pension trust exempted from current taxation.
Revenue Act of 1928	Allowed employer to take tax deductions for reasonable amounts paid into a qualified trust in excess of the amounts required to fund current liabilities.
Revenue Act of 1938	Nondiversion rule enacted. Made pension trusts irrevocable.
Investment Advisers Act of 1940	Required delegation of investment responsibilities only to an adviser registered under the act, or to a bank or an insurance company (qualified under the laws of two or more states).
Revenue Act of 1942	Tightened coverage standards for qualification, limited allowable deductions, and allowed integration of plans with Social Security.

Labor-Management Relations Act of 1947	Section 302 provided fundamental guidelines for establishment and operation of pension plans administered jointly by an employer and a union.
Revenue Act of 1950	Restricted stock options.
Social Security Amendments of: 1950 1952 1954 1958 1967	Affected pension integration provisions.
Welfare and Pension Plans Disclosure Act of 1958	Established disclosure requirements to limit fiduciary abuse.
Revenue Act of 1961	Section 403(b) amended to extend tax deferral for annuity purchases to employees of public school systems.
Welfare and Pension Plans Disclosure Act Amendments of 1962	Revised 1958 Act—shifted the responsibilities for protecting plan assets from plan participants to the federal government. Did not preserve rights of participants—just prevented fraud and poor administration.
Self-Employed Individual Retirement Act of 1962	Keogh Act (officially the Self-Employed Individual Retirement Act) adopted and subsequently liberalized by amendment; this act made available qualified pension planning for self-employed persons, unincorporated small businesses, farmers, professional people, and their employees.
Tax Reform Act of 1969	Provided that part of a lump-sum distribution received from a qualified employee's trust within one taxable year (on account of death or other separation from service) was to be given

ordinary income treatment instead of the capital gains treatment it had been given under prior law.

Under this act, the bargain element on the exercise of statutory options is a tax preference item, unless the stock option is disposed of in the same year the option is exercised.

Employee Retirement Income Security Act of 1974 (ERISA)

Signed into law September 2, 1974, ERISA was designed to protect participants in private pension plans and to provide added pension incentives to the self-employed (through changes in Keoghs) and to persons not covered by pensions (through IRAs).

Finally established legal status of employee stock ownership plans (ESOPs) as an employee benefit—codified stock bonus plan under Internal Revenue Code. Established requirements for plan implementation and operation.

Tax Reduction Act of 1975

Established the Tax Reduction Act stock ownership plan (TRASOP) as employee benefit. Provided additional 1 percent of investment tax credit for acquisitions, construction, and other capital expenditures made between February 1975 and January 1977 if employer sets up a TRASOP.

Tax Reform Act of 1976

Extended availability of TRASOP credit from February 1977 to January 1981 and added another 0.5 percent credit for employer-employee matching contributions.

Revenue Act of 1978	Extended TRASOP tax credit provisions until December 31, 1983, and required all TRASOPs to be tax-qualified if employee contributions were made for plan years beginning after December 11, 1978. Established qualified deferred compensation plans (section 401(k)) under which employees are not taxed if they elect to receive deferred compensation rather than direct cash payments.
Miscellaneous Revenue Act of 1980	Permitted tax-qualified ESOPs to provide cash distribution to a participant.
Economic Recovery Tax Act of 1981	Raised contribution limits on individual retirement accounts and Keogh (H.R. 10) plans and extended IRA eligibility to persons covered by employer pension plans. Also authorized qualified voluntary employee contributions. Permitted payroll-based tax credit instead of investment-based TRASOPs. Repealed qualified stock options. Established incentive stock options (ISOs) subject to taxation, modification, and reporting.
Tax Equity and Fiscal Responsibility Act of 1982	Repealed Keogh plan contribution limitations, established top-heavy plan category, lowered section 415 plan limitations, altered provisions allowing loans to plan participants, changed rules governing integration with Social Security, reduced estate-tax exclusion for proceeds of qualified retirement plans, set limits on age by which plan distributions must be be-

gun or completed, and established various rules aimed at personal service corporations.

Social Security Amendments of 1983

Prohibited further pullouts of state and local government employer associations after effective date of law.

Included amounts deferred in salary reduction plans as taxable compensation for payroll tax purposes.

Increased payroll taxes on self-employed persons.

Health Insurance Legislation

Revenue Act of 1939 (section 104)

Established employee exclusion for compensation for injuries, sickness, or both, received under Workers' Compensation, accident or health insurance.

Revenue Act of 1942 (section 213)

Established the medical expense deduction; the percentage limitation has decreased since this section's enactment.

Revenue Act of 1954 (section 105)

Amounts received under accident and health plans are included in employee's gross income if: (1) they are attributable to employer contributions that were not previously included in employee's gross income; or (2) the amount is paid to the employee by the employer.

Revenue Act of 1954 (section 106)

Excluded employer's contribution to accident and health plans benefiting employees. The 1954 act formally recognized that such contributions had

	always been deductible as business expenses.
Social Security Amendments of 1965	Permitted one-half of expenses paid for medical insurance, not in excess of $150, to be deducted from taxable income.
Tax Equity and Fiscal Responsibility Act of 1982	Eliminated the separate $150 deduction for one-half of health insurance premiums, and included health insurance premiums as medical expenses that may be deducted subject to the adjusted gross income floor.

Welfare Plan Legislation

Life Insurance Company Income Tax Act of 1959	Excluded from taxation the investment income attributable to insured pension reserves.
Revenue Act of 1964	Established $50,000 limit on value of life insurance that can be supported by tax-deductible premiums.
Tax Reform Act of 1976	Replaced sick pay exclusion with an exclusion of up to $5,200 a year for retirees under age sixty-five who are permanently and totally disabled.
	Provided for special treatment of group legal services as employee benefit for tax years 1977–1981.
Revenue Act of 1978 (section 105(h))	Established nondiscriminatory standards for self-insured medical reimbursement plans.
Revenue Act of 1978 (section 125)	Established "cafeteria" plans, wherein employees may choose among two or more benefits of the plan without being subject to taxation. The employees

	may elect to have the employer contribute to a profit-sharing or stock bonus plan or to be paid in cash or other benefits.
Tax Equity and Fiscal Responsibility Act of 1982	Changed rules for computing share of employer-paid group life insurance premiums to be included in employee's adjusted gross income.

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With Congress and the administration considering the taxation of employee benefits as an additional revenue source to offset large federal deficits, the Employee Benefit Research Institute sponsored a pioneering tax policy forum. Expert speakers and participants had some pointed advice for workers, the business community and Congress:

"I think all of us would agree that the pressure to raise new revenue and to limit government expenditures will continue. Whether we view tax benefits to pensions and other employee plans as government subsidies, or just as failure to collect taxes, the benefits are vulnerable under this kind of government effort. As a result, we have to expect continued investigation of their cost-effectiveness. It will be necessary to try to separate the benefits that are cost-effective from those that are not."

Daniel I. Halperin—Professor of Tax Law, Georgetown University Law Center; former Deputy Assistant Secretary for Tax Legislation, U.S. Department of Treasury

". . . I believe that national policy should nurture the private employee benefit system. These plans provide a network of economic security, not only in the event of retirement but in the event of death or illness. They also are of material value in the area of capital formation. Changes in policy can have far-reaching implications. . . . It is extremely important that these implications be thoroughly evaluated before changes are made."

Everett T. Allen Jr.—Vice President, Towers, Perrin, Forster & Crosby, Inc.; consulting editor, *Life and Health Insurance Handbook*

". . . We need better understanding and cooperation between industry and the federal government. Our collective goal should be to create a fabric for economic security. Sometimes we get so involved in the technical details—the ramifications of tax structures—that we lose the broad perspective of the purpose of benefits."

Harry G. Smith—Director of Special Projects, Corporate Human Resources, Sun Company, Inc.

"The country has developed a very fine tax-qualified benefits system. If there are obvious abuses, as somebody said, they ought to be ferreted out. I am reluctant for the government, however, to get involved in every aspect of savings plans, profit-sharing plans, and pension plans in a revenue-raising mode. On balance, this interference will do more harm to the system than the abuses will; harming the system harms American workers."

John Baitsell—Corporate Labor Relations Manager, Mobil Oil Corporation

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