EMPLOYEE BENEFITS LAW:

THE CASE FOR RADICAL REFORM

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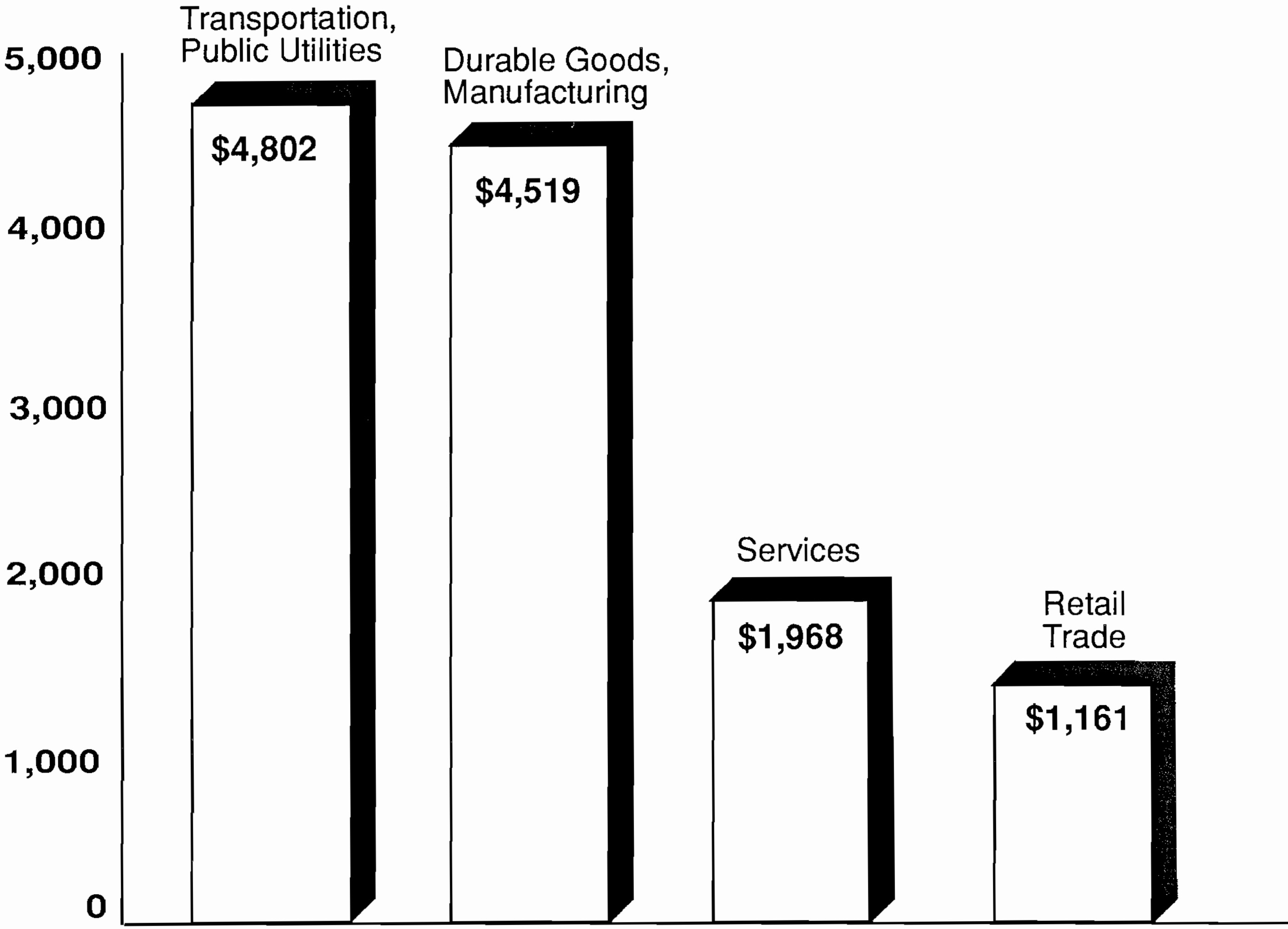
AVERAGE TAX DEDUCTIBLE
EMPLOYEE BENEFIT
5,000
4,000
3,000
2,000
1,000
0
Transportation,
Public Utilities
$4,802
Durable Goods,
Manufacturing
$4,519
Services
$1,968
Retail
Trade
$1,161

EXECUTIVE SUMMARY

Employee benefits in the United States are evolving toward a two-tier system in which some employees have lavish benefits (subsidized by taxpayers) and other employees have none.

- While health insurance in the automobile industry averages $3,055 per year per employee and is totally tax deductible, 17.5 million employees have no employer-provided health insurance.

- While 91 percent of employers of large firms have a tax-subsidized retirement pension plan, more than half of the employees in small firms have no pension benefits.

Each year America "spends" $105 billion in tax deductions for employee benefits. The deductions cause the tax rates for all taxpayers to be higher than they otherwise would be. The justification is that federal policy should encourage health insurance, retirement pensions, disability insurance, day care, etc. Yet this tax subsidy is highly arbitrary and inequitable. In general, the tax law favors employees of large firms and higher-income employees at the expense of small firms and lower-income employees.

- In retail trade, for example, the average employee benefit is one-fourth the average benefit in the transportation and public utility industries.

- Among employees who lack health insurance, 66 percent are self-employed or work for firms with fewer than 25 employees, and 92 percent have annual incomes of less than $25,000.

The employee benefits system (shaped and molded by the tax code) also has other defects. In general, the tax code:

- Encourages escalating health care costs and discourages efforts at cost control.

- Subsidizes an unlimited amount of spending on current medical expenses but discourages saving for post-retirement medical needs.

- Encourages a pension system in which workers can lose tens of thousands of dollars by switching jobs, even if they are fully vested.

The employee benefits system is in need of radical reform. We should move to a system in which all Americans are entitled to the same (limited) tax subsidy, regardless of employment. All benefits should be personal and portable. The types of expenditures that qualify for a tax deduction should include medical savings accounts to pay for small medical bills and savings for post-retirement medical care. Regulations should be no more complicated than those currently governing IRA accounts.

These reforms would be a boon to the small business sector, the fastest growing segment of our economy, and to employees of small business. They also would help large firms control health care and other employee benefit costs.

THE CASE FOR REFORM

The United States relies primarily on the private sector to provide basic human services — especially health care and retirement pensions — to American workers. Yet our health care system and our private pension system are not primarily the result of individual choice and private ownership. Instead, these very important social institutions have been shaped and molded by government policies and are administered by corporate welfare states that in many ways resemble the political welfare states of European countries.

Each year the U.S. government "spends" about $105 billion on employee benefits.[1] This is the amount of money that is not collected in taxes because employee benefits are excluded from taxable wages. Because of this exclusion, tax rates faced by all taxpayers are higher than they otherwise would be. On the average:

- For every dollar the government collects in personal income taxes, about 25 cents goes uncollected because of employee benefits.
- But for the exclusion for employee benefits, the marginal income tax rate faced by American workers could be 4 percentage points lower than it currently is.[2]
- The "tax expenditure" for employee benefits amounts to about $450 per year for every man, woman and child in the country — or about $1,000 for every American family.

Why the Current System isn't Working

Ostensibly, the huge tax subsidies for employee benefits exist because the federal government wants to promote general social goals. Yet those goals are not being met in a reasonable way. The current system is inequitable — affecting different workers and different families in radically different ways. The current system creates a false sense of security by misleading workers about the size of their expected retirement benefits. It encourages waste and inefficiency in the medical marketplace — contributing to spiraling health care costs. And tax subsidies for all employee benefits are distributed in a highly arbitrary way.

Private Health Insurance. Each year, the "tax expenditure" for employer-provided health insurance is about $48.5 billion — roughly $485 for every American family. The current system subsidizes lavish health care plans for some workers while others have no opportunity to receive a tax subsidy.

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[1]*Special Analyses, Budget of the United States Government,* Table G-2. Income tax expenditures from the Budget are $75 billion, of which one-third is tax on accruing interest from prior pension contributions, and $30 billion is foregone Social Security taxes (authors' estimate).

[2]For example, people in the 15 percent income tax bracket could otherwise be in the 11 percent tax bracket, people in the 28 percent tax bracket could be in the 24 percent bracket, etc.

- Tax-deductible health insurance expenditures range from a high of $3,055 per worker under the health care plans provided by the automobile manufacturers to as little as $793 — the average for workers in retail trade.[3]

- Self-employed individuals are allowed to deduct only 25 percent of health insurance premiums, and even this right has an uncertain future.

- Unemployed workers and employees of firms which do not provide health insurance receive no tax subsidy for the health insurance they purchase.

In general, the problem of a large number of uninsured people is a creation of the tax law. Most of the 37 million Americans who lack health insurance had no opportunity to purchase health insurance with pre-tax dollars. At the same time, current law encourages waste and imprudence among those who do have health insurance:

- In general, firms which choose scaled-down, no-frills health insurance are penalized with reduced tax subsidies.

- Employees who act as prudent buyers of health care cannot reap any cash reward for doing so without tax penalty — reflecting a "use-it-or-lose-it" national health policy.

- Employees have no opportunity (under the tax law) to opt out of an employer plan and purchase a less expensive policy on their own.

- Although the tax law subsidizes wasteful first-dollar health insurance, no subsidy is available for those who save to pay for small medical bills out-of-pocket and virtually no subsidy is available for those who pay their own medical bills.[4]

- Although the tax law excludes from income any amount an employer spends on current medical expenses, no exclusion is allowed for saving for post-retirement medical liabilities, which currently are almost completely unfunded.

Private Pensions. Because of U.S. tax law, U.S. labor law and numerous government regulations, the U.S. private pension system is predominantly a defined-benefit system. This system favors older workers at the expense of younger workers and heaps huge penalties on workers who change jobs:[5]

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[3]Aldona Robbins and Gary Robbins, "What a Canadian-style Health Care Scheme Would Cost U.S. Employers and Their Employees," National Center for Policy Analysis, NCPA Policy Report No. 145, February 1990.

[4]Medical expenses are tax deductible only to the extent that they exceed 7.5 percent of income.

[5]Dennis Logue, "Pension Plans at Risk: A Potential Hazard of Deficit Reduction and Tax Reform," NCPA Policy Report No. 119, October 1985.

- A worker earning the average wage can lose as much as $45,000 in pension benefits as a result of a single job change, even if the worker is fully vested.

- If the worker changes jobs three times over a career, the loss of pension benefits can reach $68,000.

To make matters worse, the federal government has socialized the defined-benefit pension industry through an insurance scheme that encourages healthy companies to end their pensions and financially troubled companies to unload their pension obligations on the rest of society. The result is a heads-I-win-tails-you-lose system in which workers can get burned no matter what happens:[6]

- When pension funds become over-funded, the excess often reverts to the employer, or to the new owner in a corporate takeover, rather than to the workers.

- When a company gets into financial trouble and the pension fund becomes under-funded, workers frequently receive a smaller pension than they were promised.

The one form of pension that receives the least favorable treatment under the tax code is the personal and portable pension, under which workers have well-defined property rights in the pension assets and can exercise choice over pension fund investments.

- Although as much as $30,000 is excludable from income under conventional company (defined-contribution) pension plans, tax subsidies for personal and portable pensions — 401(k) plans and IRAs — are severely restricted.

- Contributions to 401(k) plans were limited to $7,627[7] in 1989 minus any IRA contributions, and the amount is not excluded from the Social Security (FICA) tax.

- Contributions to IRA accounts are limited to $2,000[8] (provided there is no employer-provided pension) and also are subject to the Social Security tax.

Day Care. Since 1952, provisions have existed in the tax code to allow for exclusions, deductions or tax credits for day care. The theory is that day care expenses for working mothers are business expenses. The current system is highly arbitrary, however:[9]

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[6]Edward J. Harpham, "Private Pensions in Crisis: The Case for Radical Reform," NCPA Policy Report No. 115, January 1984.

[7]Or 15 percent of income.

[8]Or lower amounts for higher-income families.

[9]See David Henderson, "The Child Care Tax Credit: A Supply-side Success Story," NCPA Policy Report No. 140, July 1989, p. 6.

- Under the child care tax credit available on an individual's income tax return, the maximum tax benefit is $960.
- If the individual works for an employer who has a flexible spending account option, however, the maximum tax benefit is about $2,500.[10]
- If the employer provides day care services directly, the tax benefit is unlimited.

Principles That Should Guide Public Policy

Because of the inequities and inefficiencies in current public policy toward employee benefits, the need for radical reform is urgent. Moreover, reform should be guided by the following principles:

1. ***The tax subsidy for any employee benefit ought to be made available to all Americans on equal terms, regardless of the nature of employment.***

If there are valid social goals (health insurance, retirement pensions, day care, etc.) which merit special encouragement through the tax system, there is no valid reason why one taxpayer should receive more encouragement than another. All Americans should have equal access to tax subsidies, and this access should not be governed by the accident of employment.

2. ***All employee benefits should be individualized (a specific amount of money attributed to a specific employee), and each worker's annual employee benefits should be recorded as part of the employee's gross compensation.***

One of the most bizarre features of the U.S. employee benefit system is that, although we know how much in the aggregate is spent on employee benefits, we do not know the value of benefits any particular employee has received.[11] This practice has a number of adverse consequences. First, the current system perpetuates the myth that employee benefits are "gifts" from employers rather than something employees have "earned." Second, the current system allows older workers (who usually make the decisions about employee benefit packages) to reap subsidies from younger workers in socially undesirable ways. Third, the current system perpetuates a retirement pension and retirement health care system under which individuals often have no well-defined property rights in the promised benefit and thus may not receive it. Fourth, the current system encourages waste and inefficiency in health care because there often is no relationship between individual workers' consumption of health care and the health insurance premiums their employers pay.

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[10]The maximum benefit (without tax penalty) is $5,000. If an individual faces a 50 percent marginal tax rate (federal income tax, state and local income tax, and FICA tax combined), the tax benefit is 50 percent of $5,000. Note: Under the Family Support Act of 1989, a family must choose either the Dependent Care Credit or a flexible spending account.

[11]In some cases, the value of group benefits is attributed to individual employees — but only after the benefit exceeds a certain amount. For group life insurance coverage in excess of $50,000, the fair market value of the insurance benefit is treated as imputed income to the employee and the employee is taxed on that amount. No similar provision exists for group health insurance, however.

These adverse consequences would be eliminated if workers knew the value of the benefits they receive and perceived these benefits as an alternative to the payment of money wages.

3. ***All individuals should be allowed to make choices among tax-free benefits and should also be allowed to chose between nontaxed benefits and taxable income.***

Most large corporations now have flexible benefit programs. These allow employees to choose among a a variety of tax-free benefits (e.g., less health insurance and more pension benefit or vice versa). The vast majority of American workers do not have this right, however. Because the legal and accounting expenses are so large and the compliance regulations so cumbersome, most small and medium-sized companies are effectively precluded from operating a flexible benefit program. In general, even employees of large firms may not choose between taxable income and nontaxed benefits (e.g., more wages and less health insurance coverage).

These restrictions unfairly penalize workers and deny them the opportunity to shape their tax-free benefit package to individual and family needs.

4. ***The amount of tax subsidy available to any individual should be limited.***

Under the current system, there are very few limits. For example, employers can spend an unlimited amount of money on employee health care plans and employer-provided day care with no tax penalty. The amount that can be spent on conventional pensions is (for all practical purposes) unlimited for most employees. Thus, people in some sectors of the economy have access to a blank check drawn on the U.S. Treasury, while millions of others have access to few or no tax subsidies.

5. ***Public policy should encourage personal and portable pensions.***

A sound pension system is one in which individuals know how much they have "saved" for their retirement and can plan accordingly. In addition, a dynamic, growing economy requires a flexible labor force. Accordingly, public policy should encourage rather than discourage labor mobility.

6. ***Public policy toward health insurance should encourage all reasonable efforts to control rising health care costs.***

The current system is designed to encourage the purchase of too much health insurance, which subsidizes wasteful spending. Almost any health care plan which gives employees incentives to be prudent buyers in the medical marketplace suffers tax penalties. These features of our tax code are in urgent need of reform.

7. ***Public policy should encourage private savings to fund medical expenses during retirement.***

Although the current system provides generous — in principle, unlimited — subsidies for employer spending on current health care needs, the same is not true of savings to pay for health care during the retirement years. Individuals receive no tax subsidy for such savings

and employers have very limited options. As a consequence, only 2 percent of post-retirement health care liabilities of U.S. employers are pre-funded. Just as the federal government's Medicare program is operated on a pay-as-you-go-basis, federal tax law is encouraging a pay-as-you-go-approach for all other sources of funding for the medical expenses of the elderly.[12] These policies are unwise and imprudent.

What follows is a closer look at specific problems and proposed solutions.

FEDERAL TAX LAW AND EMPLOYEE BENEFITS

Federal tax law has an enormous impact on the employee benefit plans of employers because marginal tax rates are so high. Even a moderate wage earner in the U.S. economy gets to keep less than 70 cents out of each additional dollar earned. The federal income tax rate for this worker is 15 percent and the combined (employer plus employee) Social Security tax rate is 15.3 percent. Thus, federal taxes take 30.3 cents out of each additional dollar of wages. If this employee faces a 6 percent state and local income tax, the marginal tax rate is 36.3 percent, leaving the employee with less than two-thirds of a dollar of wages in the form of take-home pay.

As Table 1 shows, workers in the 28 percent federal income tax bracket face a marginal tax rate of 43.3 percent — leaving them with less than 57 cents in take-home pay out of each additional dollar of earnings. If state and local income taxes apply, the situation is much worse. Indeed, millions of American workers take home less than 50 cents of each additional dollar they earn.

Because of these high tax rates, the tax code gives employers and employees strong incentives to replace wages with nontaxable benefits in the employees' compensation package. These incentives are irresistible if the benefit is something employees would have purchased anyway without any tax subsidy. Even if the benefit would not have otherwise been purchased, federal tax law makes certain benefits very attractive.

For example, Table 2 shows the value of non-pension benefits (health care, day care, life insurance, etc.) relative to the payment of a dollar of wages. As the table shows:[13]

- For a worker in the 15 percent tax bracket, federal tax law makes a dollar of wages equivalent to $1.44 in employee benefits.

- For a worker in the 28 percent bracket, a dollar of wages is equivalent to $1.76 in employee benefits.

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[12] John C. Goodman and Gerald L. Musgrave, "Health Care After Retirement: Who Will Pay the Cost?" NCPA Policy Report No. 139, June 1989.

[13] The value of the benefit equals $1/(1-t)$, where t is the marginal federal income tax rate plus the combined employer-employee Social Security payroll tax rate. For a worker in the 15 percent bracket, $t = 0.15 + 0.153$. For a worker in the 28 percent bracket, $t = 0.28 + 0.153$.

TABLE 1

AFTER-TAX VALUE OF A DOLLAR OF MONEY WAGES

Federal Tax Category	No State and Local Income Tax	State and Local Income Tax
FICA Tax Only	85¢	81¢[1]
FICA Tax Plus 15 percent Income Tax	70¢	64¢[2]
FICA Tax Plus 28 percent Income Tax	57¢	51¢[2]

[1] State and local income tax rate equals 4 percent.

[2] State and local income tax rate equals 6 percent.

TABLE 2

VALUE OF A DOLLAR OF EMPLOYEE BENEFITS

(Relative to Taxable Wages)

Federal Tax Category	No State and Local Income Tax	State and Local Income Tax
FICA Tax Only	$1.18	$1.24[1]
FICA Tax Plus 15 percent Income Tax	1.44	1.56[2]
FICA Tax Plus 28 percent Income Tax	1.76	1.97[2]

Note: Table shows the amount of taxable wages that are equivalent to a dollar spent on an employee benefit.

[1] State and local income tax rate equals 4 percent.

[2] State and local income tax rate equals 6 percent.

If an employer paid a worker in the 28 percent federal income tax bracket $1.76 in wages, the workers' take-home pay would only be $1.00 after taxes are paid. On the other hand, if the $1.76 is spent on a nontaxed benefit, the worker gets the full value of the benefit.

Nontaxed employee benefits become even more lucrative if workers face state and local taxes. Take workers facing 6 percent state and local income tax rate, for example.

- For a worker in the 15 percent federal income tax bracket. the combined effect of all taxes is to make a dollar of wages equivalent to $1.56 in employee benefits.

- For a worker in the 28 percent federal income tax bracket, the combined effect of all taxes is to make a dollar of wages equivalent to $1.97 in employee benefits.

Given the size of these incentives, it is not surprising that employers and employees take advantage of them whenever they can. For example:

- On the average, workers in durable manufacturing receive employee benefits equal to 19 percent of earnings.

- For a manufacturing worker in the 28 percent tax bracket, employee benefits are equal to almost one-fourth of take-home pay.

- Put another way, higher-paid manufacturing workers are receiving almost one-fourth of their after-tax income in the form of employee benefits.

HOW THE TAX LAW DISCRIMINATES AGAINST SMALL FIRMS

Despite the fact that the tax subsidies for employee benefits are "paid" by all taxpayers, the benefits of these subsidies are not spread equally throughout the American economy. As Table 3 shows:

- Employees of large firms are 21 percent more likely to have employer-provided health insurance and 37 percent more likely to have life insurance than employees of small firms.

- Employees of large firms are more than twice as likely to have a retirement pension and more than three times as likely to receive educational benefits.

In general, small firms represent the fastest growing segment of the economy and are providing most of the new jobs. Nonetheless, employees of these firms are receiving the fewest tax subsidies for employee benefits.

TABLE 3

PERCENT OF EMPLOYEES WITH BENEFITS (1988)

Employee Benefit	Medium & Large Firms	Small Firms
Health Care	96.0%	74.7%
Life Insurance	96.0	58.6
Retirement Pension	91.0	43.3
Educational Assistance	76.0	23.0
Long-Term Disability Insurance	48.0	25.6
Child Care	1.0	4.3

Source: Employee Benefit Research Institute, *Employee Benefit Notes*, Washington, DC, December 1989, Vol. 10, No. 12, Table 3.

TABLE 4

EMPLOYEE BENEFITS BY INDUSTRY

Industry	Average Earnings	Average Benefits
Transportation & public utilities	$25,678	$4,802
Mining	29,022	4,527
Durable goods manufacturing	23,809	4,519
Construction	26,142	4,078
Nondurable goods manufacturing	20,307	2,692
Wholesale trade	20,406	2,408
Finance, insurance, & real estate	17,630	2,080
Services[1]	15,746	1,968
Retail trade	9,839	1,161

[1]Estimate based on the average employee benefit as a percent of earnings (12.5 percent) for all other industries.

Source: Employer-provided benefits as a percent of earnings are from the U.S. Chamber of Commerce, *Employee Benefits, 1988 Edition, Survey Data from Benefit Year 1987*, Washington, DC, March 1989. Earnings are derived from average weekly earnings for July 1989, published by the Bureau of Labor Statistics.

Table 4 shows the distribution of employee benefits by industry. As the table illustrates:

- In the transportation and public utility industries, employees on the average receive $4,802 per year in non-taxed benefits.
- By contrast, employees in retail trade receive only $1,161 per year in non-taxed benefits.
- This means that the tax subsidy for transportation and public utility workers is more than four times the subsidy for workers in retail trade.

Regulations That Penalize Small Firms

Why do small firms (and industries dominated by small firms) provide fewer employee benefits? The reason is that federal tax law governing employee benefits discriminates against small firms in three ways.

Interfering With Labor Market Contracts. In general, the more competitive a market the more essential it is that workers receive a compensation package equal to the value of what they produce. The smaller the firm the more important this principle is.[14] This means workers with different skills must receive a different total compensation, and the form of the compensation package must be the one most preferred by the worker. The easiest way to achieve this objective is for the employer and the employee to agree on the total amount of compensation and for the employee to choose the specifics (i.e., how much in wages, how much in health insurance, etc.)

Employee benefits law, however, is designed from top to bottom to prevent benefit packages from being tailored to the needs of individual employees. The implicit philosophy behind employee benefits law is that all employees should receive the same benefit and that employees should not be able to choose between taxable wages and nontaxed benefits. This approach to employee benefits is devastating for small firms in competitive markets.

Burdensome Administrative Costs. The rules and regulations governing employee benefits cover thousands of pages. Because complying with them is so costly, many employee benefit programs allowed under the tax code can be administered only by large firms — companies that can spread these costs out over a very large number of employees.

Unreasonable compliance rules. Regulations governing some employee benefits are relatively easy for large firms to meet, but impossible for small ones.

Take 401(k) pension plans, for example. The requirement that 70 percent of employees *actually* participate (not just be offered participation) precludes many small firms from even trying to establish the benefits. Quite apart from the administrative costs, the compliance rules are decisive for these companies.

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[14]Large firms have the opportunity to average out deviations from the principle over a larger number of workers.

Case Studies

As illustrations of how these rules and regulations are especially harmful to small business, consider how they affect the decisions to offer health insurance or retirement pension benefits.

Health Insurance. Suppose a small firm is considering purchasing an individual health insurance policy for each employee. The first problem is that the cost of the policy will vary depending on the age of the employee. (A 60-year-old male, for example, is three times more expensive to insure than a 25-year-old.) The obvious solution is to pay the premiums for the policies and reduce each worker's salary by the premium amount. The second problem is that not all employees may want health insurance (e.g., some may be covered by another policy). The obvious solution is to give health insurance only to those employees who want it, reducing the salary of each by the amount of the premium.

The third problem is that some employees may have preexisting illnesses, and the insurer may want to insert exclusions and riders into their policies. The obvious solution is to get each employee the best possible deal. The fourth problem is that employees may have different preferences about the content of their policies; some may want to trade off a higher deductible for a lower premium while others want coverage for different types of illnesses and medical services. The obvious answer is to let each employee choose a policy best suited to the employee's needs and preferences.

These solutions may seem obvious, and they may be to the advantage of every single employee. However, these solutions to health insurance problems are forbidden under federal law. In general, the tax law forbids employees from choosing between wages and health insurance and insists that all employees be offered the *same* coverage on the *same* terms.

The result is that the employer must turn to a more expensive group policy with a package of benefits no single employee wants. The employer also may decide not to offer health insurance at all.

Pension Benefits. Suppose a small firm is considering providing a pension benefit for its employees. As Table 5 shows, the most attractive option is a conventional pension fund. The tax subsidy here is even greater than for health insurance. Quite apart from the huge administrative costs (caused by complicated regulations), the employer will quickly discover that pension benefits face the same obstacles as health benefits. Individual preferences and needs vary widely, but employee benefits cannot be individualized.

Then the employer discovers the 401(k) plan. If the substantial administrative costs are ignored, this plan has attractive properties. Employees can contribute any amount they wish (up to $7,627[15] in 1989 or 15 percent of income) and take advantage of tax-deferred income. Each employee's account is personal and portable, and employees can have individual discretion over investment decisions. The employer does not even have to match the employee contribution.

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[15]The amount is indexed to the rate of inflation in future years.

TABLE 5

RELATIVE VALUE OF A DOLLAR CONTRIBUTED TO RETIREMENT SAVINGS FOR A 35-YEAR-OLD WORKER[1]

Federal Tax Category	Conventional Pension Fund[2]	401(K) or IRA[3]	Ordinary Savings Account[4]
FICA Tax Only	$1.50	$1.27	$1.00
FICA Tax Plus 15 Percent Income Tax	1.83	1.55	1.00
FICA Tax Plus 28 Percent Income Tax	2.70	2.29	1.00

Note: Table shows the amount of taxable wages that are equivalent to a dollar deposited in each of the accounts.

[1]Rate of interest equals 9 percent; future tax rates the same as today's tax rates.

[2]No Social Security tax paid; income tax deferred.

[3]Social Security tax paid; income tax deferred.

[4]After-tax contributions; no tax deferred.

The problem is that 70 percent of employees have to participate. Moreover, the amount that any one employee can contribute depends on what all others are contributing. Because smaller firms tend to pay lower wages, the employees of small firms are less likely to contribute to pension plans, on the average. Moreover, because employees of small firms tend to be in lower tax brackets, the tax subsidy for pension contributions is lower.

As a result, the 70 percent participation requirement may be prohibitive for small firms. Even if the firm does meet the test initially, a change in preferences on the part of one or two employees may cause the plan to fail the test. Given the very large setup costs, this could be a very expensive development. For example, consider a firm with 10 employees, seven of whom are participating in a 401(k) plan. If one secretary ceases to participate, the entire plan is disqualified.

Table 6 shows how firms of different sizes respond to these incentives. Despite the fact that the 401(k) plan provides an ideal method for employees to save, such plans are very rare among firms with fewer than 25 employees. By contrast, they are quite common among firms with at least 250 workers.

TABLE 6

PARTICIPATION IN 401(k) PLANS BY SIZE OF FIRM, 1988

Number of Employees	Coverage[1]	Participation[2]
Less than 10	2.9%	2.1%
10 - 24	8.0	5.6
25 - 49	14.1	7.7
50 - 99	18.0	10.9
100 - 249	22.9	13.4
250 +	41.5	23.3

[1]Percent of employees who work for an employer who offers the benefit.

[2]Percent of all employees who participate in a 401(k) plan.

Source: Employee Benefit Research Institute, "Individual Saving for Retirement — The 401(k) and IRA Experiences," *EBRI Issue Brief*, October 1989, No. 95, Table 4, p. 7.

Results of Discrimination

As a result of the discrimination against small businesses, America is developing a two-tiered system with respect to health insurance, retirement pensions and other socially desirable benefits. On the one hand, some large companies provide cradle-to-grave benefits for each stage in a worker's life: marriage, pregnancy, child rearing, divorce, retirement and death. Many large companies now offer day care and elder care for dependents, medical coverage for stepchildren in remarriages, and job search assistance for the second spouse when a two-career couple relocates.[16] On the other hand, 17 million employees and their dependents have no health insurance and 52 million are not covered by a retirement pension.[17]

Moreover, those employees who have the best benefits tend to have above-average incomes, while those who have few or no benefits tend to earn less than the average. As Table 4 shows, the industries in which employees have the highest incomes also have the highest benefits, both in absolute terms and as a percent of income.

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[16]"More Benefits Bend with Workers' Needs," *Wall Street Journal*, January 9, 1990.

[17]Source: EBRI, "Pension Coverage and Benefit Entitlement: New Findings from 1988," *EBRI Issue Brief*, September 1989, No. 94, calculated from Table 1, p. 7.

HOW THE TAX LAW CONTRIBUTES TO ESCALATING HEALTH CARE COSTS

America's health care system has been shaped and molded by our tax system. Of those Americans who have health insurance, 89 percent have acquired it through an employer,[18] and the type of health insurance employers provide is insurance that responds to the incentives and obeys the regulations of the tax code. The following is a partial list of ways in which the tax law encourages waste and discourages prudence in the purchase of health care.

Subsidizing Over-insurance. As noted above, the tax subsidies for health insurance are quite large. For a highly paid employee (facing a 6 percent state and local income tax rate), $1.97 of health insurance is equivalent to $1.00 of wages. This encourages employees to prefer overly generous health insurance coverage — coverage that they would not buy out-of-pocket without tax subsidies. For a highly paid employee, $1.97 spent on health insurance need only have a value of $1.01 to be preferable to $1.97 of wages. If paid in wages, the employee will be left with just $1.00 of take-home pay. Moreover, higher-paid workers tend to dictate the contents of employee benefits plans.

Partly because of these incentives, employer-provided health insurance can cover illnesses ranging from alcoholism and drug abuse to anxiety and depression. It can cover medical services ranging from acupuncture to *in vitro* fertilization and the services of providers ranging from chiropractors to naturopaths.[19]

Once employees have coverage for these services, the services tend to be used. Thus health care spending is much higher than it otherwise would be — and so are health insurance premiums.

Encouraging First-dollar Health Insurance Coverage. One of the strange features of the tax code is that a physician's fee paid by an employer (or an employer's insurance carrier) is paid with pre-tax dollars, whereas fees paid out-of-pocket by employees must be made with after-tax dollars. As a result, the tax law encourages (subsidizes) 100 percent health insurance coverage with no deductibles and no copayments for all medical expenses. Unfortunately, this is the most wasteful type of health insurance. For one thing, it usually costs an insurance company more than $50 to administer and monitor a claim for a $50 physician's fee, which effectively doubles the cost of the health care. For another thing, people are far less prudent in purchasing health care if the bills are paid by someone else.

Severing the Relationship Between Health Insurance Benefits and Employee Wages. As noted above, the easiest way for employers to escape from the burden of rising health care costs is to allow employees to choose their health insurance plan and deduct the

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[18]Employee Benefit Research Institute, "A Profile of the Nonelderly Population without Health Insurance," *EBRI Issue Brief*, May 1987, No. 66, calculated from Table 2, p. 3.

[19]In many states, health insurance benefit laws passed by state governments mandated group health insurance to cover these services. Federal tax law encourages these laws by making the benefits tax deductible. See John C. Goodman and Gerald C. Musgrave, "Freedom of Choice in Health Insurance," NCPA Policy Report No. 134 , November 1988.

premium from that employee's pre-tax salary. In this way, employees exercise maximum choice and still get the advantages of a tax subsidy for health insurance. This procedure has other advantages as well. When there is a direct link between salary and health insurance premiums, employees will be more prudent about the policy they choose. For example, employees who want policies with no deductibles and all the bells and whistles will pay the full premium cost in the form of a salary reduction. Faced with this choice, employees are more likely to choose high-deductible, no-frills catastrophic insurance.

In general, however, it is difficult to individualize employee health insurance in this way under current law — even for large companies. As a result, employee benefits law encourages employers to adopt the same policy for all employees. In many cases employees do not know what the premiums are. In those cases where they do know (e.g., where they pay part of the premium), each employee is charged the same premium — regardless of age, sex, place of work, type of work or any other factor that affects real premium costs.

The upshot is that the individual employee sees no relationship between the cost of employer-provided health insurance and personal take-home pay. Small wonder that employees of large companies demand lavish health care benefits. They have no reason not to make such demands.

Penalizing Cost Control Efforts. Just as there is no direct relationship between an individual employee's salary and the value of the employee's health insurance benefits, so there is no relationship between wasteful, imprudent health care purchases and salary under the conventional health plans of most corporations. Under most policies, it is as though the employee has a company credit card to take to the hospital equivalent of a shopping mall. The employee will find many interesting things to buy, all charged to the employer. Under this system, employees have no personal incentives to be careful, prudent buyers of health care.

Employee benefits law discourages cost control efforts in other ways. The easiest way to hold down premium increases is to choose health insurance policies with high deductibles. Table 7 presents the marginal cost (premium increase per additional dollar of coverage) of buying down the deductible on a representative health insurance policy. As the table shows:

- Lowering the deductible from $750 to $500 costs 55 cents in additional premiums for each additional dollar of insurance coverage.

- Lowering the deductible from $500 to $250 costs 62 cents in additional premiums for each additional dollar of insurance coverage.

While these lower-deductible policies may prove to be a good buy from the point of view of an individual, they cannot possibly be a good buy for policyholders as a group. On the average, these policyholders are paying far more in premiums than they will "collect" in medical expenses. Table 7 shows an even more bizarre phenomenon:[20]

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[20]These figures are for individual policies sold by Golden Rule Insurance Company. Other companies sell similar policies at similar prices. As of 1989, Golden Rule Insurance Company no longer sells policies with a $100 deductible. People who previously had such policies, however, may renew them at the indicated prices.

- Lowering the deductible from $250 to $100 costs $2.14 for each additional dollar of insurance coverage.

- Policyholders who choose this option are paying $1.14 more than any possible benefit they could derive from each additional dollar of coverage.

Low-deductible insurance policies, then, are not only wasteful, but in some cases policyholders pay more than any possible value that could be gained from the extra coverage. Yet the tax law discourages high-deductible policies. On a $1,000-deductible policy, for example, the first $1,000 must be paid out-of-pocket with after-tax dollars. If that $1,000 were paid by employer-provided insurance, the premium could be paid with pre-tax dollars, thus providing a tax subsidy.

TABLE 7

COST OF A LOWER-DEDUCTIBLE HEALTH INSURANCE POLICY

(Male, Age 40)[1]

Lowering the Deductible[2]			Additional Premium	Cost of Each $1 of Additional Coverage[3]
$1,000	→	$750	$97.49	49¢
$ 750	→	$500	$109.93	55¢
$ 500	→	$250	$124.56	62¢
$ 250	→	$100	$256.82	$2.14

[1]Assumes the policyholder lives in a city with average health care costs. Figures are for 1989.

[2]Policy has a 20 percent copayment up to a maximum of $1,000.

[3]Because the policy has a 20 percent copayment, additional coverage is 80 percent of the difference between the two deductibles.

Source: Golden Rule Insurance Company.

HOW THE TAX LAW IS CONTRIBUTING TO THE RISING NUMBER OF PEOPLE WHO LACK HEALTH INSURANCE

One of the great ironies of employee benefits law is that although it was designed to encourage the purchase of health insurance, its more perverse provisions are increasing the number of people without health insurance. Because employers cannot individualize health insurance benefits, many are turning to other practices to control their health insurance costs. The following are some examples:

Small and Intermediate-Sized Firms. Because employee benefits law prevents smaller firms from adopting a sensible approach to employee health insurance, many are responding to rising health insurance premiums by cancelling their group policy altogether. Often, employers will give bonuses or raises in an attempt to pass on to employees the gain from eliminating the health insurance benefit. Employees are then encouraged to purchase individual health insurance policies (with after-tax dollars) on their own. Many, of course, do not.

Large Firms. Unable to adopt a sensible approach to employee health insurance, many large firms are asking employees to pay (with after-tax dollars) a larger share of the premium. Often employers will pay most of the premium for the employee, but ask employees to pay a much larger share for their dependents.[21] These practices result in some employees' opting not to buy into an employer's group health insurance plan. More frequently, employees choose coverage for themselves but drop coverage for their dependents. Indeed, one of the ironies of employer-provided health insurance is that three million people who lack health insurance are dependents of employees who are themselves insured.[22]

HOW THE TAX LAW DISCOURAGES SAVING FOR POST-RETIREMENT MEDICAL EXPENSES

As we move into the next century, one of the most frightening social problems will be the problem of paying for retirement pensions and medical care for the elderly. Since both Social Security and Medicare are pay-as-you-go programs in which there are no current savings to meet future obligations, tomorrow's obligations will have to be met mainly by taxes on tomorrow's workers. The bill will be high. According to reasonable projections:[23]

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[21]Kenneth H. Bacon, "Business and Labor Reach a Consensus on Need to Reduce Health Care Costs," *Wall Street Journal*, November 1, 1989.

[22]Employee Benefits Research Institute, "A Profile of the Nonelderly Population without Health Insurance," *EBRI Issue Brief*, May 1987, No. 66, p. 7.

[23]These projections are based on the Social Security Administration's pessimistic projections. See Goodman and Musgrave, "Health Care after Retirement," Table III, p. 6.

- By the year 2000, total health care expenses for the elderly will equal 14.3 percent of workers' payroll, and health care plus Social Security will equal 20.89 percent.

- By the year 2050, total health care spending for the elderly will equal 46 percent of payroll, and health care plus Social Security will equal 69.2 percent.

Currently the elderly pay about one-third of their own health care expenses. If we can continue that practice, the future burden for workers will be lower, but still quite high:[24]

- If the elderly continue to pay one-third of their health care costs, the combined burden of health care for the elderly and Social Security for workers will be 17.7 percent of payroll by the year 2000.

- The burden for workers will reach 54.5 percent of payroll by the year 2050.

In the year 2050, retirees, on the average, will be older than they are today, and as retirees age they tend to have fewer assets and less income from assets. Thus it will be increasingly difficult for the elderly to pay one-third of their health care costs.

Clearly the need is to arrange a system in which the elderly can pay much more than one-third of their medical expenses — relieving future workers of an almost impossible burden. But in order for that to happen, there must be increased savings by today's workers to meet post-retirement medical needs.

Yet, although the federal government subsidizes spending on current medical needs to the tune of $45.8 billion, individuals have no opportunity to engage in tax-subsidized savings for post-retirement medical needs.[25] Corporations are also greatly constrained in their ability to put aside funds today for the post-retirement health care expenses of their employees. As a result, the federal government is forcing employers to adopt much the same pay-as-you-go approach that characterizes Medicare and other government health care programs for the elderly. Although one-third of all employees are employed by a company which provides post-retirement health care benefits, currently:

- Unfunded liabilities for post-retirement health care for U.S. employers are as high as $2 trillion.[26]

- If Fortune 500 companies were required to account for post-retirement health care benefits the way they now account for pensions, their annual net income would be reduced by 30 to 60 percent.[27]

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[24]*Ibid.*

[25]Jonathan C. Dopkeen, *Post-retirement Health Benefits,* Pew Memorial Trust Policy Synthesis, 2, Health Services Research, Vol. 21, No. 6, February 1987, p. 810.

[26]Employee Benefit Research Institute, *Measuring and Funding Corporate Liabilities for Retiree Health Benefits,* (Washington, D.C.: EBRI, 1988), p. xv.

[27]*Ibid.,* p. xvi.

We face a future nightmare because of federal policy. The tax law discourages both individuals and employers from saving and investing today to pay for health care tomorrow.

Characteristics of Post-retirement Health Care Benefit Plans

As Table 8 shows, promises of post-retirement health care benefits are very prevalent among the largest firms. The smaller the firm, however, the less likely the benefit will be available. For those who have the benefit, it is an extremely valuable one — often more valuable than a retirement pension. But even employees of large firms have no guarantee that they will receive it. Frequently, only employees who work for a firm at the time of their retirement are entitled to post-retirement medical benefits. Those who leave the firm earlier usually receive no benefit. Moreover, after retirement, a retiree's medical benefits often can be reduced, since most companies do not view the benefit as a contractual obligation.[28] The following are some common characteristics of post-retirement health care benefits provided by employers:

TABLE 8

PERCENT OF U.S. EMPLOYERS OFFERING POST-RETIREMENT HEALTH CARE BENEFITS BY SIZE OF FIRM

Number of Employees	Percent of Firms Offering Benefit
50 - 99	42%
100 - 499	46%
500 - 999	62%
1,000 - 4,999	77%
5,000 - 9,999	89%
10,000 +	95%

Source: Jonathan C. Dopkeen, Mercer Meidinger

[28]Christopher Drew and Michael Tarket, "Pension Plans Contribute to Retirement Risks," *Chicago Tribune*. Reprinted in the *Dallas Morning News*, January 7, 1990.

TABLE 9

THE RELATIONSHIP BETWEEN FINAL SALARY AND THE PRESENT VALUE OF POST-RETIREMENT HEALTH CARE BENEFITS

Retirement at Age 65

Final Salary	Present Value of Health Care Benefits	Percent of Final Salary
$100,000	$32,000	32%
$50,000	$32,000	64%
$25,000	$32,000	128%
$15,000	$32,000	213%

Retirement at Age 55

Final Salary	Present Value of Health Care Benefits	Percent of Final Salary
$100,000	$55,000	55%
$50,000	$55,000	110%
$25,000	$55,000	220%
$15,000	$55,000	336%

Source: Martin J. Zigler, *Post-retirement Health Care Benefits*, Tillinghast, Nelson and Warren, Inc., 1985, pp. 25 ff. Cited in Jonathan C. Dopkeen, "Post-retirement Health Benefits: Pew Memorial Trust Policy Synthesis 2," *Health Services Research*, Vol. 21, No. 6, February 1987, Table 2, p. 814.

Like the defined-benefit pension, post-retirement health care benefits are defined benefits. They involve even more redistribution of income among employees than typical pension plans.

1. **Post-retirement health care benefits usually offer the same benefits to all retirees, regardless of final salary.** As Table 9 shows, in a representative post-retirement health care benefit plan there is no relationship between employees' salaries, or their productivity, and the benefit offered. For example, among 55-year-old retirees, the benefit is equal to about 55 percent of salary for a $100,000-a-year worker and equal to about 336 percent of salary for a $15,000-a-year worker.

2. **Unlike defined-benefit pensions, post-retirement health care benefits are indexed.** Because the benefit is a service rather than cash benefit, its cost rises with medical inflation and increased utilization of health care services. For this reason, post-retirement health care benefits are usually more valuable than pension benefits for low-income employees. In a representative plan:[29]

   - Among 55-year-old retirees earning $25,000 a year, post-retirement medical benefits are almost twice as valuable as pension benefits.

   - Among $15,000 a year employees, medical benefits are more than 3-1/2 times as valuable as pension benefits.

3. **The value of post-retirement benefits is unrelated to years of service to the firm.** Unlike pension benefits, employees receive either full post-retirement medical benefits, or they receive nothing. Moreover, benefits are usually totally unrelated to the worker's lifetime service to the firm. In one survey of 250 large companies:[30]

   - At the normal retirement age, 43 percent of the companies provide the benefit with no years-of-service requirement.

   - An additional 43 percent of the companies offer the benefit to employees who have spent five years or less with the firm.

4. **Retirees usually pay little or no premium for their health insurance coverage.** The elderly who are covered by employer-provided health insurance pay very little in premiums. For example:[31]

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[29]Dopkeen, "Post-retirement Health Benefits," p. 814.

[30]*Ibid.*, p. 805.

[31]*Ibid.*, p. 806.

- Among retirees with individual coverage, 55.8 percent make no premium payment.
- Among retirees with coverage including their spouse, 46.5 percent make no premium payment.
- Only 3.5 percent of all companies require their retirees to pay the "full premium," and even in these cases, the "full premium" is the average premium paid by all employees — not the actuarially fair premium.

Public Policy Problems

Employer-provided health insurance benefits, as currently structured, are troublesome from the point of view of public policy. Employers cannot make promises of post-retirement benefits to young workers because the commitments would be open-ended and the federal government makes it impossible for employers to fund the promise over their employees' work life. Employees today cannot possibly know whether they will be covered by employer-provided health insurance during their retirement since there is no guarantee they will be employed by any particular employer at or near their retirement. Thus, employees cannot integrate personal financial planning for their retirement years with employer-provided benefits.

It is not clear why federal policies toward employee benefits have evolved to their current state. What is clear is that many corporate managers are prepared to change:[32]

- In a recent survey of corporate benefits officers, 80 percent favored tax-deductible or tax-exempt medical IRAs.
- These accounts would be funded by contributions of employees and their employers, would grow in value over the work life of employees and would be the private property of the worker.

HOW THE TAX LAW UNDERMINES PRIVATE PENSIONS

In principle, the tax law encourages savings through private pensions. Funds deposited in a qualified pension account escape income taxes and Social Security taxes at the time of deposit. Interest earnings on the pension funds also escape taxation at the time they are earned. Retirees do have to pay income taxes on pension benefits at the time pension funds are withdrawn and realized as personal income. But the ability to avoid Social Security taxes and the opportunity to defer the payment of taxes until the time of retirement makes pension funds the most valuable of all employee benefits. As Table 10 shows:

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[32]"Introduction and Survey Highlights of the EQUICOR Health Survey VI: Looking to the Future of Retiree Health Benefits," in Robert Paul and Diane Disney, *The Sourcebook on Postretirement Health Care Benefits* (Greenvale, NY: Panel, 1988), p. 108.

- For a 20-year-old worker in the 28 percent income tax bracket, a dollar deposited in a pension fund is worth $3.95 of taxable wages.

- For a 30-year-old in the same tax bracket, a dollar deposited in a pension fund is worth $3.07 in wages.

At least in principle, the tax law generally favors younger workers because the ability to defer taxes is more valuable the longer the time between pension fund deposits and withdrawals. Despite this fact, younger workers are less likely to have pensions than older workers. As Table 11 shows, those industries which are dominated by small firms and are creating most of the new jobs for young workers have the smallest percentage of firms with any type of pension plan. Moreover, when younger workers are participating in a pension plan, odds are that the plan favors older workers and leaves younger workers with highly uncertain benefits. Before we examine the reasons for this phenomenon, let's look at the characteristics of an ideal pension system.

TABLE 10

PRESENT VALUE OF A DOLLAR DEPOSITED IN A PENSION FUND FOR WORKERS OF DIFFERENT AGES[1]

Age of Worker	15% Bracket	28% Bracket
20	$2.24	$3.95
30	1.96	3.07
40	1.71	2.38
50	1.49	1.85
60	1.30	1.44

Note: Table shows the amount of taxable wages equivalent to a dollar deposited in a pension account.

[1]Assumes 9 percent interest rate; future tax rate same as today.

TABLE 11

WORKERS COVERED BY PENSION PLANS, 1988

Industry	Percent of Workers Covered
Federal Government	93%
State & Local Government	91
Communication Utilities	75
Durable Manufacturing	72
Mining	70
Finance, Insurance, Real Estate	69
Non-Durable Manufacturing	68
Professional Services	56
Wholesale Trade	54
All Industries	54
Transportation	51
Construction	34
Retail Trade	34
Business & Personal Services	27

Source: Employee Benefit Research Institute, "Pension Coverage and Benefit Entitlement: New Findings from 1988," *EBRI Issue Brief*, No. 84, September 1989, calculated from Chart 5, p. 12.

An Ideal Pension System: Personal and Portable Pensions[33]

Employees at most nonprofit educational institutions participate in a unique pension system. Under the plan, employees and their employers contribute to independent pension funds which make investments on the workers' behalf. By far the largest of these is the Teachers Insurance and Annuity Association — College Retirement Equities Fund, or TIAA-CREF. With about $25 billion in assets, the fund manages pension money for almost 800,000 people associated with over 3,400 educational institutions. These include most private colleges and universities, and research institutes such as the Brookings Institution and the National Bureau for Economic Research.[34]

In many ways these plans resemble private savings plans more than traditional pension plans. Workers contribute a certain percentage of their salaries, and a portion of these contributions is matched by the employer. The funds are then invested by professional managers. Workers cannot be certain what pension income they will receive during their retirement years; that depends on how much is set aside and how well the investments perform. They do enjoy a different kind of certainty, however. Contributions to the pension plan are the private property of the individual worker, and the funds are managed by people who are independent of the special interests of company managers and union officials.

These features of the pension system used by nonprofit educational organizations lead to many advantages for the individual worker:

- **Protection from adverse contingencies: layoffs, injuries and job changes.** Because pension contributions are the property of the individual workers, workers do not lose their pension benefits when they change jobs or lose employment due to layoffs, firings, sickness or injuries. Moreover, workers who switch to a new employer participating in the same plan simply carry their pension accounts with them.

- **Inclusion in a worker's estate.** Because workers own their pension contributions, the accumulated funds become part of their estates and pass to their heirs in the event of death.

- **Protection from employer bankruptcy.** Because employers do not control or own pension fund money, employees do not lose their promised pension benefits in the event of employer bankruptcy. Contributions are fully paid at the same time as wages.

- **Protection from employer shenanigans.** Employer contributions to the pension plan are comparable to the payment of wages. Employers cannot decide to reduce these contributions simply because times are bad or in order to meet other company objectives. Nor can employers grab the excess assets of high-performing

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[33]This section is based on Edward J. Harpham, "Private Pensions in Crisis: The Case for Radical Reform."

[34]See Christopher Conte, "More Schools Break Ties to Academe's Major Pension Fund," *Wall Street Journal*, September 19, 1983, p. 35.

pension funds by unilaterally terminating the pension plan, or use pension fund money to fight off mergers or to purchase the company's own stock.

- **Protection from union shenanigans**. Pension fund money also is independent of unions. Corrupt union officials cannot line their pockets with fat management fees or divert funds to questionable investments.

- **Independent investment decisions**. Pension fund investments are made by independent professional managers with the same fiduciary responsibilities as the trust departments of commercial banks. Funds are managed for the direct financial benefit of the workers and not for the special interests of others.

- **Choice of investment strategy**. Within the TIAA-CREF plan, workers have the option to choose an investment strategy: all stocks, all bonds or a combination of the two.

- **Choice of investment managers**. Although the TIAA-CREF fund still dominates the market, many educational institutions allow employees to choose among as many as 30 different funds. This creates a virtual financial cafeteria for workers who wish to exercise their own preferences about how their pension money should be invested. In addition, in many cases employees directly elect the trustees who manage the fund.

- **Protection from the failure of other pension funds**. When workers direct their own money to the pension fund of their choice, they cannot impose the cost of their bad decisions on others. Conversely, they are insulated from the bad decisions of other workers and other pension fund managers. Of greatest importance, employees of nonprofit educational institutions are not subsidizing the failures of less well-constructed pension plans in other parts of the economy.

- **No discrimination**. Employers are obligated to contribute a fixed percent of a worker's salary to the pension fund. They do not promise any specific pension benefit upon retirement, so complaints of discrimination do not arise. Women live longer than men; whites live longer than blacks; non-smokers live longer than smokers. But these differences in life expectancy are irrelevant as far as the pension plan is concerned.

- **Guarantees of a reasonable pension**. If workers invest their funds conservatively in a broad range of stocks and bonds, they can be assured that their pension investments will reflect the good and bad fortunes of the economy as a whole. If the economy experiences high growth, pension assets will grow more rapidly. The reverse is also true. At retirement, however, workers can expect their pension income to bear some reasonable relationship to the average income in the economy.

How the Current System Differs from an Ideal System

The pension plans of nonprofit educational institutions are called *defined-contribution* plans. Under these plans, the employer is obliged to make specific, periodic contributions but assumes no obligations to the worker during the retirement years. In contrast, the most prevalent type of pension plans found elsewhere in the economy are *defined-benefit* plans. Under these plans, which now cover about 30 million workers, employers promise to provide specific pension benefits during the retirement years but make no specific commitment concerning annual contributions.

At first glance, it might seem that defined-benefit plans are superior because the worker gets a promise of a specific retirement income. In fact, these plans are the cause of most problems in the private pension industry. One reason is that workers under these plans put all of their eggs in one basket: the financial health of their employer. Over a working career of 45 years, that can be risky. Another reason is that workers do not have property rights in pension fund contributions. Most important, pension fund investments frequently reflect the special interests of company managers and union officials, not the financial interests of the beneficiaries.

Loss of Promised Benefits. Workers can lose their pension benefits under defined-benefit plans through job changes, firings, layoffs, loss of employment due to sickness or injury or other adverse contingencies. Only workers who have been employed by the company for a minimum number of years and are "vested" keep their benefits in these circumstances.[35]

Workers also can lose pension benefits because companies find themselves unable to pay the promised benefits. In 1974, the federal government established an insurance program to bail out financially troubled defined-benefit plans with funds collected from healthy ones. But under this system (discussed below), worker pensions are far from secure.

The Structural Flaw in Defined-benefit Pension Plans. Aside from these defects, there is a more basic problem with defined-benefit pension plans. They are based on a flawed view of the world. The defined-benefit pension system imagines a labor market in which employees work for the same employer until they retire, and the employer remains a profitable and viable entity for this entire time period. Indeed, on what other assumptions would a 21-year-old worker contract with an employer to pay a pension 45 years hence? This image stands in stark contrast to reality. In a dynamic, capitalist economy, companies rise and fall. In a labor market where there is high mobility, workers change jobs frequently over the course of a career.[36]

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[35]Vesting refers to the requirements that an individual must meet in order to acquire a right to pension benefits. A worker is partially or fully vested after working a certain number of years for an employer. After becoming vested, a worker retains rights to certain pension benefits even if employment terminates before retirement.

[36]Data obtained from the Bureau of Labor Statistics, U.S. Department of Labor.

- On the average, a male worker in the U.S. economy has been working for his current employer for only 6.9 years.

- A female worker in U.S. economy has been working for her current employer for only 4.8 years.

The very nature of the defined-benefit pension plan makes it least attractive to those sectors of the economy where there is high labor mobility and short job tenure. This may explain the pattern of pension benefits shown in Table 11. Clearly, the defined-benefit pension system is inappropriate in a dynamic economy which places a premium on having all workers provide for their own retirement.

Yet another way in which workers can lose benefits is by simply switching jobs, even though they are fully vested. This is because defined-benefit pension plans typically are "backend loaded." They reward workers who stay with the firm throughout their work life and punish workers who leave. As noted earlier in this report, an average wage worker who is fully vested in an employer's pension plan can lose tens of thousands of dollars as a result of a single job switch in mid-career. The more job switches, the greater the loss.[37]

Socializing the Private Pension Industry. As noted above, in 1974 the federal government established a pension insurance scheme for defined-benefit pension plans. Federal pension insurance resembles federal insurance for savings and loan institutions far more than it resembles a genuine insurance, however. All companies with defined-benefit plans must participate, and all pay the same premiums, regardless of the financial health of the company and the riskiness of the plan. Because financially healthy companies have little to gain from the deal, an increasing number are terminating their defined-benefit plans. By contrast, companies such as Braniff and LTV are counting on pension insurance to pay benefits to their retirees.

The Role of Federal Policy

Federal policy has encouraged defined-benefit pensions in a number of ways. First, under the structure of federal labor law, the union representatives who negotiate employee benefit arrangements with management are almost always older, more senior workers. Small wonder that the pension system they prefer is one which subsidizes older workers at the expense of younger ones. Second, federal tax law allows companies to time their contributions to defined-benefit plans in a way that maximizes the tax advantage of such contributions. Third, representatives of management who negotiate pension benefits are virtually always high-income employees, as is the entire senior management itself. Under federal tax law, high-income employees can receive more tax-favored pension benefits through a defined-benefit pension plan than through a defined-contribution plan.

The personal and portable pension, then, has not been a casualty of freedom of choice in competitive markets. The ideal pension has been rejected because of the incentives created by federal law.

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[37]See Dennis Logue, "Pension Plans at Risk: A Potential Hazard of Deficit Reduction and Tax Reform."

PROPOSALS FOR REFORM

Under the current tax law, expenditures for employee benefits are not included in the employee's taxable income (and, therefore, are effectively deductible) if paid by employers. This tax advantage is denied to individuals who purchase the same benefits on their own. As a result, many individuals do not have health insurance, a pension plan and other socially desirable "fringe benefits." Those who do, often are participating in plans designed to meet the needs of corporate bureaucracies rather than individual and family needs. Although employee benefits law appears to benefit large corporations, many corporate employers are finding their employee benefit plans a threat to the financial health of their companies.

Dismantling the Corporate Welfare State. Absent the tax law, the only reason for employers to provide fringe benefits rather than paying higher wages would be the economies of scale that might make employer-arranged group purchases the most cost-effective choice for some employees. If such economies exist, they should be uncovered through free market competition rather than artificial tax incentives. Additionally, employees should be free to integrate personal savings, personal health insurance and employment fringe benefits into rational, life-long financial plans. In order to achieve these objectives, however, it is necessary to make major changes in the employee benefit policies of most companies — and in the tax law.

Economic theory teaches that the value of a worker to a firm is equal to the worker's contribution to production and sales. Other things equal, employees will tend to receive salaries and fringe benefits equal to the value of what they produce. Yet in many corporations the value of fringe benefits is only loosely related — even unrelated — to the workers' productivity. Since employers cannot successfully compete in the marketplace unless their total labor costs are roughly equal to the value of their employees' collective output, considerable redistribution of income takes place within the modern corporation. The failure to match individual compensation with individual productivity, however, is a major impediment to the goals of employees and to the company's goal of successfully competing in an international marketplace.

Creating Equity and Fairness in the Tax Law. Currently, the tax law creates artificial distinctions between individuals who receive fringe benefits from employers and individuals who purchase identical benefits on their own. As a practical matter, the law discriminates against employees of small firms, the self-employed and the unemployed. When the tax law is combined with the fringe-benefit policies which it subsidizes, individual planning for the retirement years becomes almost impossible.

A better way is to allow all individuals — regardless of employment status — to retain a certain portion of their earned income tax free, provided that income is used for well-defined purposes. A deduction of 11 percent, for example, would make this proposal revenue neutral. Under this proposal, the cash value of every qualified fringe benefit would be attributed to a specific employee. The tax law would remain neutral, however, with respect to the manner in which such benefits were acquired. For example, some workers might wish to obtain low-premium catastrophic health insurance through their employer and place the

premium savings in their own medical IRA to self-insure for small medical bills. Others might prefer to have their employers maintain cash balances in individual medical accounts in addition to company-provided health insurance.

The important goal is to maximize individual and company freedom of choice in planning for income security and health care needs. This will permit individual preferences and market forces — rather than the tax law — to determine the choices.

NOTE: Nothing written here is to be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder passage of any bill before Congress.

APPENDIX A

THE EVOLUTION OF INDIRECT FEDERAL REGULATION OF EMPLOYEE BENEFITS

Specific favorable tax treatment of employee benefits began in the 1920s with pensions. Tax law allowed employers to deduct contributions they made to retirement trust funds for their employees. Because of extremely high personal exemption amounts, the individual income tax affected only relatively affluent individuals.[1] Thus, pension coverage went primarily to executives, managers and stockholder employees.[2]

During the 1940s, however, the structure of the income tax changed substantially. The personal exemption was reduced and tax rates escalated rapidly.[3] Pensions became even more attractive to higher-income individuals. Because many lower-income workers were now paying income taxes, however, pensions could help reduce their tax bills as well.

In an effort to assure pension availability to the broad base of wage and salary workers, tax legislation in 1942 introduced "nondiscrimination" measures. It specified that for a pension plan to qualify for favorable tax treatment:

> At least 70 percent of full-time employees with five or more years' service had to be eligible for the plan's benefits, or the plan had to provide benefits to at least 80 percent of eligible employees if at least 70 percent of full-time employees were eligible.[4]

By mandating minimum eligibility standards for pension plans to qualify for favorable tax treatment, the federal government gained a new foothold over the makeup of labor compensation.

Regulation of pensions plans in particular, and employee benefits in general, was greatly increased with the Employee Retirement Income Security Act of 1974 (ERISA).

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[1]In 1929, the personal exemption for a married couple was $3,500 ($31,380 in 1990 dollars). The tax was 1.5 percent of the first $4,000 ($35,780) in net income less exemptions; 3 percent of income between $4,000 and $8,000 ($71,562 in 1990 dollars); and 5 percent of income over $8,000. The average tax rate on the first $67,110 in income, expressed in 1990 dollars, was less than 0.8 percent compared with today's average tax rate of 20 percent on the same income. In other words, today's federal income tax rate is 25 times higher. For historical tax information see Fritz Scheuren and Jane McCubbin, "Individual Income Tax Shares and Average Tax Rates, 1916-1950," Internal Revenue Service, *Statistics of Income Bulletin*, Winter 1988-89, pp. 1-70.

[2]Norman B. Ture with Barbara A. Fields, *The Future of Private Pension Plans* (Washington, DC: American Enterprise Institute for Public Policy Research, 1976), pp. 33-34.

[3]In 1945, the personal exemption for a married couple was $1,000 ($8,338 in 1990 dollars) and the standard deduction was $500 ($4,169 in 1990 dollars). The normal tax rate was 3 percent of net income less deductions plus a surtax that ranged from 20 percent of income under $2,000 to 91 percent of income over $200,000. The average tax rate on the first $3,500 ($30,338 in 1990 dollars) was 2.1 percent, one-tenth of today's rate.

[4]Ture, *The Future of Private Pension Plans*, p. 34.

ERISA's main concern was making sure that workers who were covered by pension plans actually received benefits in retirement through vesting and funding requirements.

Vesting refers to the amount of pension benefits workers are entitled to, even if they leave their current employers. ERISA established vesting rules which were more liberal than the common practice.[5] It required that a worker be 25 percent vested after 5 years of service, gradually increasing to 100 percent by 15 years.

Funding refers to the pension plan assets which back up the promised benefits. Despite the fact that most pension plans were adequately funded, ERISA imposed stiffer requirements.[6] It also established complex rules and regulations governing the conduct and operations of plan fiduciaries.

Whatever its good intentions, ERISA raised the cost of pension plans. As a result, many experts predicted that ERISA would lead to less, not more, pension coverage for American workers. The data on pension plan creation and termination seem to confirm these forecasts. From 1956 to 1974, the year ERISA was enacted, the number of pension plans grew at an average of 15 percent per year. From 1975 to 1982, however, the average annual growth rate slowed to 7 percent. Plan terminations also increased. In the three-year period between 1975 and 1977, 18,857 defined-benefit plans were terminated, compared with 15,512 during the previous 19 years.[7]

More recent tax legislation continues the trend of increasing pay package regulation. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Deficit Reduction Act of 1983 (DEFRA), the Consolidated Budget Reconciliation Act of 1985 (COBRA) and Section 89 of the Tax Reform Act of 1986 (later repealed) place additional restrictions on the scope of employer-provided employee benefits. The legislative intent behind these regulations was to expand the availability of employee benefits to a larger share of the workforce and to "even out" the benefits going to higher-paid versus lower-paid employees to achieve some notion of "fairness."

The implementation of this legislative intent led to arbitrary rules on what constituted an acceptable employee benefit program. The rules reached their ultimate expression in Section 89 with a highly complex set of arithmetic formulas and a requirement that employees not merely be offered the right to participate but that they also choose to participate.

Compliance with TEFRA, DEFRA, COBRA and Section 89 meant that employers had to undertake recurring, thorough reviews of their existing employee benefit programs and, if necessary, restructure them. Each change in the law brought added administrative costs. To

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[5]*Ibid.*, p. 85. About 13 percent of plans had no vesting requirements prior to ERISA. For those plans with vesting rules, most combined age and service, generally 40 to 45 years of age with 15 to 19 years of service.

[6]*Ibid.*, pp. 89-91.

[7]Sylvester J.Schieber, "The Effect on Private Pension Plans of Pension Provisions in the Tax Equity and Fiscal Responsibility Act of 1982," statement before the U.S. Senate Committee on Finance, Subcommittee on Savings, Pensions, and Investment Policy, Washington, DC, April 11, 1983. Figures are based on data in Table 1.

the extent that these added costs led employers to cut back on employee benefit programs, the ultimate effect of the regulations was exactly opposite to their intent.

APPENDIX B

TRENDS IN EMPLOYEE BENEFITS

Between 1948 and 1983, employee benefits as a percent of labor compensation more than quadrupled from 1.9 percent to 8.6 percent. This growth came at the expense of money wages whose share of labor compensation declined from 95.4 percent to 83 percent. The third component of the pay package, employer contributions for social insurance, followed a growth path similar to employee benefits. Social insurance taxes went from 2.7 percent of labor compensation in 1948 to 8.5 percent in 1983.

The growth in employer social insurance taxes is due to the expanding Social Security and Medicare programs. In 1948, a combined employer-employee payroll tax rate of 2 percent on the first $3,000 in wages collected more than enough taxes to pay Social Security benefits. By 1983, however, revenues from a combined tax rate of 13.4 percent on the first $35,700 in wages just barely paid Social Security and Medicare benefits. The trend of higher payroll taxes continued through the 1980s. By 1990, the combined Social Security payroll tax rate will be 15.3 percent on the first $51,300 of wages.

The growth in employee benefits and the decline in the relative importance of money wages is also related to taxes. If a dollar in employee benefits trades exactly for a dollar in money wages, common sense tells us that workers would choose money wages because they can be spent on anything, including employee benefits. Employee benefits and money wages are not an even trade, however. Depending on a worker's marginal tax rate, a dollar of employee benefits buys more after-tax than a dollar of money wages. Over the last several decades, taxes on American workers have more than tripled. The economy-wide average marginal tax rate on U.S. labor compensation increased from 10 percent in 1956 to 31.4 percent in 1986.[1]

The ever-increasing tax on labor has continued to improve the attractiveness of employee benefits relative to money wages. On average, a dollar of money wages bought $1.11 in employee benefits in 1956, $1.28 in 1970, and $1.43 in 1981. As the relative value of employee benefits grew, so did their component of the pay package, from 3 percent in 1956 to 5.5 percent in 1970 to 8.5 percent in 1981.

Empirical evidence supports the common sense reasoning that a major reason for the growth in employee benefits has been the increasing tax on labor. Data between 1956 and 1987 show that a 10 percent increase in the average marginal tax on labor led to slightly more than a 10 percent increase in the share of employee benefits in labor compensation.[2]

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[1]The economy-wide average marginal tax rate on U.S. labor compensation consists of: (1) the marginal federal income tax on wages and salaries based on tax return data from the Internal Revenue Service's *Statistics of Income* (SOI), (2) the marginal state and local income tax based on state and local taxes as a percent of adjusted gross income from the SOI, and (3) the marginal Social Security payroll tax rate adjusted for expected benefits.

[2]The regression results are as follows: $EB = -0.00238 + 0.28121\ TXL \quad R^2 = .86$
(13.79)
where EB is the share of employee benefits in labor compensation and TXL is the economy-wide average marginal tax rate on labor compensation. The T-statistic is given in parentheses.

Just as increases in marginal tax rates make employee benefits more attractive, decreases in tax rates make them less attractive. The decline in the share of employee benefits since 1983 coincides with decreases in the marginal tax on labor as a result of the rate reductions in the Tax Acts of 1981 and 1986.[3]

Future growth in employee benefits may also be slowed due to increasing government regulation of pensions and other employee benefit programs. Continuing increases in health care costs will likely dampen growth as well. Although rapid inflation in medical prices and health insurance premiums have put upward pressure on employee benefits during the 1980s, continuing increases could lead to cutbacks in coverage and benefits as businesses try to control labor costs.

MANDATED BENEFITS

In times of tight government budgets, employer-provided employee benefit programs present inviting targets. Rather than directly spend government revenue to achieve social goals such as health insurance for the uninsured, parental leave or child care, legislators may think it politically expedient to require that employers provide the benefits.

Mandates have two common characteristics: (1) they remove freedom of choice from the labor market and substitute the preferences of politicians for the preferences of workers, and (2) they threaten to lower the take-home pay of workers by reducing productivity and/or requiring employers to substitute employee benefits for money wages. A basic reality of the labor market is that employers will not hire employees unless the value of what they produce is at least equal to the total compensation they receive. As a result, when employers are forced by law to provide specific benefits, the cost of those benefits ultimately will be borne by workers — through either wage reductions or reductions in other parts of the compensation package. To the extent that mandated benefits also lower productivity, employees will bear an additional cost because lower productivity ultimately means lower compensation.

Mandated benefits may appear to cause employee benefits to grow faster. The net effect, however, will be to cause labor compensation to grow more slowly, leaving workers worse off. The end result is that mandates simply tell workers how they must spend their money.

[3]The 1981 personal income tax rate cuts were largely offset by increases in the Social Security payroll tax rate. A drop in the average marginal rate from 31 percent to 28 percent did not occur until 1988 when the full impact of the 1986 Tax Reform Act was felt.