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Tax Reform and the Impact on Employee Benefits

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Table of Contents

Executive Summary 1

Introduction 2

The Current System 3

Alternative Tax Proposals 5

Repercussions for Employer-Based Health Insurance 7

Repercussions for Employer-Sponsored Pensions 9

Annuities and Life Insurance Products 11

Conclusions and Alternatives 12

Endnotes 13

Executive Summary

Many politicians and economists are advocating far-reaching changes to the tax system in the United States. Each leading proposal—a tax on consumption, a tax on wages, and a value-added tax on businesses—would eliminate current tax incentives for employer-sponsored benefits.

Employee benefits, chiefly health insurance and pension programs, are important underpinnings to the economic security of American families. A key consideration in any debate on tax reform should be the effect on retirement savings and health care coverage.

Impact on Health Insurance

• Almost 150 million Americans receive health insurance through employer-sponsored group plans. Under employer-sponsored plans, even high-risk individuals are covered because the risk is spread across large groups of employees. Healthy employees maintain health insurance because the employer pays a substantial portion of the premium. This system ensures that most Americans get needed health care, government assistance is minimized, and health-care providers face less uncompensated care. In addition, administrative costs are lower per person when spread over many employees, and adverse selection is minimized through the use of group plans.

• If individuals are required to pay taxes on the full value of their employer-paid insurance, the cost of health coverage could increase by anywhere from 15 to 50 percent of the employer's contribution. Many employees would drop coverage because of the steeper cost. The loss of tax incentives also might lead employers to reduce or eliminate health insurance programs. Even a small decrease in employer health plans could result in a significant increase in the uninsured population. The result could be reduced coverage, strains on health-care providers and increased public pressure for government involvement in health care.

• However, a tax on employer-paid health insurance would have certain economic advantages. Revenue to the federal government could be increased by over $50 billion. Also, without the subsidy of employer-sponsored plans, employees might spend their health-care dollars more efficiently, thus introducing more discipline into the market. On the other hand, the efficiencies of managed care would be lost if individuals paid for their health care on a fee-for-service basis.

Impact on Retirement Savings

• Pension plans also would be greatly affected by current tax reform proposals. Without clear tax advantages many small employers would drop their pension plans. Larger employers also might follow suit if their competitors in the labor market offered higher wages instead of pensions. Pension plans would be terminated and replaced by voluntary employee savings plans or non-qualified plans, which have no rules to ensure that most employees benefit.

• Large-scale elimination of private pensions would mean a fundamental change in Americans' retirement planning. The bulk of savings for retirement is through employer-sponsored pensions. For the economy, pension plan assets of more than $4 trillion represent a huge source of efficiently invested capital and are particularly important in view of the nation's low overall savings rate. For employees, increased reliance on savings programs would transfer the risks of financing retirement security onto individual families, who usually invest more conservatively than pension plans. Low participation rates in Individual Retirement Accounts (IRAs) among employees without a pension plan show that many individuals—especially low-income workers—will not save as much as their employers were saving for them. In addition, retirement funds may not stay saved: Americans often spend lump-sum pension withdrawals for current consumption instead of rolling them over into new retirement accounts. The long-term consequences of underfunded retirements could increase the economic strain on the elderly and their families and indirectly increase demand for government programs.

Preserving Incentives

In short, eliminating the current tax incentives will have significant cost in terms of reduced retirement savings and health coverage. Policy makers must carefully weigh the expected benefits of tax reform, such as increased tax revenues and possible increases in economic efficiency, against these costs. If the costs associated with reduced coverage are judged to outweigh the benefits of reform, several options are available to achieve many of the goals of tax reform while minimizing the damage to retirement savings and health coverage.

• Incremental implementation could minimize the impact. For example, any of the proposed systems could allow a phased-in 60 percent deduction for employer health insurance costs. In addition, the tax code could continue to exempt employer health costs from FICA taxes. Pension plans could receive a tax credit and retain the FICA exemption. These measures, as well as simplification of pension laws and higher pension limits, could encourage employers to maintain pension plans.

• Congress could provide additional incentives for individual savings without eliminating the relative tax advantage of pension plans. This could be accomplished by taxing investment income at a lower tax rate. Alternately, Congress could allow

more people to make tax-deductible contributions to IRAs or increase the allowable dollar amount of contributions. In addition, IRA contributions could receive tax credits instead of tax deductions, which vary by the income level of the contributor. Tax credits would give new incentive for IRA participation to low-income individuals, whose savings rate most needs to be increased.

• Congress also might consider increasing excise taxes on early withdrawals from pension plans to preserve those funds for retirement income. An increased excise tax would increase both national savings and tax revenue.

Further discussion among elected officials, business leaders, and employee benefit professionals are necessary to accurately determine both the benefits and costs of tax reform, and may reveal solutions that achieve many of the goals of tax reform while maintaining broad-based employee pension and health plans. These programs represent an important foundation for the financial security of American families and cannot be replaced easily through individual effort. Congress must weigh the value of a strong employer-sponsored health and retirement system against the other advantages of tax reform.

Introduction

Unlike past measures, current tax reform proposals go well beyond simplifying the tax code, closing loopholes, and lowering rates. Proponents suggest that the current tax system discourages savings, investment, and economic growth. They would change this by not taxing savings or investment income. This change would greatly reduce the tax preference for employer-sponsored retirement plans, annuities, and certain forms of insurance relative to other forms of savings. The proponents also would eliminate other tax preferences under the current system, including those to encourage employer-sponsored health insurance. Their goal is to broaden the tax base and reduce the effects of tax rules on the decisions of businesses and individuals. This reflects the belief that taxing some uses of money differently than others distorts economic decisions, resulting in an inefficient allocation of resources and thus a net reduction in societal welfare.

Because of the crucial role played by employer-provided benefits in national economic and social planning, employee benefits should emerge as a major consideration of any new national tax system. Thus, the Academy was invited by Congress to examine the repercussions of tax reform on employee benefits and insurance.

This report addresses the impact of the current and alternative tax systems on employee benefits (particularly employer-sponsored health insurance and pension plans) and the people affected by them (employers, employees, dependents, health care providers, insurance companies, and the nation). It examines important issues in the analysis of retirement income and health care and effects that must be included in any general economic model of tax reform. Tax reform will have advantages and disadvantages outside these areas, which this report does not address. The report's conclusion provides ways to modify the proposals to both encourage adequate health care and retirement savings and still meet many of the objectives of tax reform. We encourage continued debate on this subject so that Congress can decide whether the advantages of tax reform outweigh the negative consequences in such areas as health and retirement and whether the advantages of the alternative tax incentives suggested in this report outweigh their costs.

The Current System

The current tax system taxes individuals in proportion to income and generally does not tax income until received. Businesses are taxed on their profits. Individuals are taxed on their income, which includes earnings on investments as well as wages and income from other sources, such as business or rental income. Pension contributions and unrealized capital gains are not taxed until they are received or realized.

Although simple in concept, in practice the current tax code has become quite complicated. To encourage some types of behavior and discourage others, the current tax code includes innumerable exclusions, exemptions, deductions, tax credits, depletion allowances and an array of depreciation schedules. For individuals, deductions are allowed to encourage home ownership and charitable giving. Large medical expenses are deductible as are significant job expenses and taxes paid to state and local governments.

The tax code also encourages employer-sponsored health insurance and retirement savings for a majority of Americans. The above items not only add complexity to the code, they cost the government in lost revenue[1] and may cause inefficient and inappropriate decision-making.

It is important to note that not all incentives are created equal. For example, immediate incentives are generally more effective than deferred incentives, monetary incentives more effective than non-monetary. The size of monetary incentives is also important, with large amounts having more impact than small ones. Small incentives may have insignificant or no impact. In addition, some incentives may not have to be as large as they are today, in order to have the same or adequate impacts.

Current Tax Incentives for Health Insurance. An employer may deduct contributions to its health plan as a business expense. In fact, employer contributions to health insurance are never taxed since workers do not pay taxes on the value of the employer's contribution nor on the health benefits/reimbursements received.[2] In contrast, individuals who purchase health insurance on their own must do it with after-tax income.[3] For many workers these taxes are substantial. They include federal income taxes of 15 percent to 39.6 percent, as well as state and local income taxes. For workers earning less than the $65,400 Social Security wage base in 1997, there is a 7.65 percent FICA tax on both the employer and the employee, which pays for Social Security and Medicare. Thus, the total marginal tax can exceed 50 percent for middle-income taxpayers just under the wage base (28 percent federal + 7 percent state[4] + 15.3 percent FICA) and high-income taxpayers who live in locales with a high income tax (39.6 percent + 8 percent state[4] and local + 2.9 percent Medicare). Even individuals with very low incomes can experience a marginal tax of more than 40 percent when their Earned Income Tax Credit is being phased out. For the average employee, the marginal tax rate is 35 percent to 40 percent.

Avoiding this tax is a strong incentive for employers to sponsor health insurance. To illustrate, an individual with a 40 percent marginal tax bracket who acquires health coverage for two people with personal funds may have to earn $6,000 per year to pay $3,600 for the insurance. To pay the employee $6,000, the employer would have to increase revenue by $6,459 (to also cover the employer FICA tax). Alternatively, the employer could just pay the $3,600 premium, for an immediate economic gain of almost $3,000 (which can be used to increase wages, after reduction for taxes, or decrease prices). It must be noted here that FICA taxes provide increased Social Security benefits to the employee, the value of which are generally about equal to the tax for many people (and about one-half of the tax for individuals above the second bendpoint in the Social Security benefit formula—approximately $32,000 currently). Thus, when Social Security benefits are included in the analysis, avoiding the FICA tax is less a tax incentive than it initially appears. Therefore, for most workers the strongest incentive is the income tax exclusion.

Current Tax Incentives for Pensions. The tax incentives for employer-sponsored pensions are also substantial. Income taxes are deferred on the employer's pension contributions and all investment income as long as the money remains in the pension plan. This tax incentive alone can double the after-tax retirement income achievable through individual savings[5]. (See Table 1.) For example, assuming a marginal income tax rate of 25 percent and an investment return of 6 percent, savings of $2,000 will produce $4,686 after tax in 30 years, while a pension would produce $8,615 after tax. This calculation assumed that the individual's tax bracket in retirement is the same and that savings receive the same rate of return as the pension plan, which is generally not the case. If the tax bracket is lower in retirement or the pension plan has a higher rate of investment return (which is typical), the $8,615 pension distribution would be even larger. Note that the tax advantage for pensions (second column) is also greater for:

- longer deferral periods,
- higher investment returns, and
- higher marginal tax rates.

For example, if we assume the employee is always in a 35 percent marginal tax bracket, $2,000 in savings would become $3,357 after 30 years, while a pension plan would provide the same employee $7,467. This can be better understood by noting that up-front taxes equal to 25 percent of a contribution have the same economic impact as taxing 25 percent of the distribution at the end. The real tax incentive for individuals whose tax bracket does not change after retirement is that pension investment income is not taxed. Thus, the tax incentives for pension plans include:

- immediate deduction of pension contributions (sometimes only a psychological incentive),
- tax-free investment income (often the most valuable incentive),

Table 1
Effect of Current Tax Rules on Savings

	Personal Savings	Qualified Pension
Initial Contribution	$2,000	$2,000
Employer FICA tax[1]	- 142	- 0
Net Employer Contribution	$1,858	$2,000
Employee FICA Tax	- 142	- 0
Employee Income Tax[2]	- 464	- 0
Post-Tax Contribution	$1,251	$2,000
End of year 1:		
Fund Balance[3]	$1,326	$2,120
Tax on Investment Income[2]	- 18	- 0
Balance after taxes	$1,308	$2,120
Tax if distributed[2]	- 0	- 530
Distribution at yr 1	$1,308	$1,590
Distribution at yr 30[2,3]	$4,686	$8,615
Distribution at yr 30 assuming:		
35 percent tax bracket [3]	$3,357	$ 7,467
interest = 8 percent [2]	$7,187	$15,094

[1]The FICA tax rate on the employer (ER) is 7.65 percent of wages (wages equal the employer contribution AFTER reduction for the employer FICA tax on it). Thus, wages (or net ER contribution) equal $2,000 ÷ 1.0765 = $1,858. The FICA tax of 7.65 percent on the employee (EE) is reflected on a later line. These FICA taxes can provide a larger Social Security benefit up to the value of the FICA tax, and thus are less of an economic benefit than they initially appear. The value of the additional Social Security benefit is at most only one-fourth the difference in the 30th year distributions above, so the major tax incentive is due to deferral of the other taxes. For employees earning over the Social Security Wage Base, the FICA tax is reduced to only the 1.45 percent Medicare tax on employer and employee, each. For such a person, the $4,686 30th year distribution would become $5,431, which is still much less than the $8,615 amount from the pension plan.

[2]Assuming a marginal tax rate of 25 percent (federal, state, and local) on contribution, investment earnings, or distributions, as applicable. This also assumes that savings are taxed annually (i.e., not invested in stocks or a home and held until retirement).

[3]Assuming an investment return of 6 percent per year.

- avoidance of FICA taxes (which are not as much an economic benefit as they appear, because they may provide a larger Social Security benefit up to the value of the FICA tax), and
- the advantage of possibly lower tax brackets after retirement.

These tax preferences have proven strong inducements for employers to sponsor health and retirement plans.

Results for Health Care. Almost 150 million Americans receive health insurance through their employers.[6] Even poor health risks are covered by spreading them across large groups of employees. The healthy employees are still willing to enroll, because the employer pays a substantial portion of the premium to receive the tax advantages. This ensures that most Americans get necessary health care, providers are paid, cost to the taxpayer is minimized, and uncompensated care is less likely to be paid by employers or providers. In addition, administrative costs per person are lower when they are spread over many employees, and adverse selection[7] is minimized through the use of group plans.

The combination of employer contributions, group insurance purchasing, employer administration, and tax incentives serves to lower the direct cost to the employee. On average, employers pay 75 percent of the premium for single coverage and 70 percent of premium for family coverage. The coverage is generally comprehensive with modest cost-sharing requirements.

However, the current system also has *disadvantages.* Individuals without employer-provided coverage do not get the tax incentive which raises concerns about equity. They also lose the efficiencies of group enrollment, and suffer the effects of adverse selection. As a result, these individuals pay more for less generous coverage or cannot get coverage. About 40 million non-elderly individuals do not have health insurance coverage. Some people lack it for short periods of time (e.g. between jobs). A majority of temporary and part-time employees and their families have no private insurance coverage. Low-income employees are less likely to have health insurance through their employer. In addition, the tax advantages are greater for individuals in higher tax brackets and cost the nation in lost revenue, which could be used in other ways. Furthermore, since employee contributions are not tax-advantaged, the tax incentives encourage employers to pay for most of the health plan costs and provide generous health benefits with small copayments, deductibles, and coinsurance. Since

employees have comparatively little incentive to economize, this may encourage over-utilization and possibly raise prices in the absence of managed care.[8] Finally, there are portability problems that could keep people locked into their jobs they may not like. For example, people with poor health records may be afraid to change jobs because they may not be able to get health coverage at their next employer. The Comprehensive Omnibus Budget Reconciliation Act (COBRA) and Health Insurance Portability and Accountability Act of 1996 address some of these problems. However, employees who do not have the 18 months of prior coverage necessary to qualify for health insurance with the new employer may still slip through the cracks and not be able to obtain coverage.

Results for Pensions. Employer-sponsored pension plans cover about half of all workers in the nation. However, the proportion of full-time, permanent workers over age 40 covered by a pension plan from current or previous employers exceeds two-thirds. To qualify for favorable tax treatment, employer pension plans generally are required to cover a broad cross-section of employees, including younger and older employees, highly paid and lower-paid, full-time and some part-time. Pension plans allow workers to retire with a more adequate income without needing government welfare, assist employers in attracting, retaining, retiring, and promoting employees, and provide more than $4 trillion in investments for the U.S. economy.[9]

There are *disadvantages* to the pension system too. Gaps in coverage are quite pronounced among small employers and also part-time and temporary workers. Pensions can be inadequate for those employees who could not contribute much to their 401(k) plan. Defined benefit plans[10] can lock people into jobs they don't like (or they will lose pension benefits);[11] while lump-sum cashout provisions can encourage employees to change jobs just to get a lump sum. Due to the tax incentives (expenditures) which cost the government revenue,[12] Congress heavily regulates pension plans with complex rules, greatly increasing the employer's administrative burden (and also discouraging some employers from establishing or maintaining plans). Pension plans may also discourage employees from being responsible about saving for their own retirement.

Alternative Tax Proposals

This report examines three alternative tax systems:

- a *consumption tax* on the individual,
- a *value added tax (VAT)* on the employer, and
- a *wage tax* on the individual.

In order for this report to be helpful to current and future debate, only the general method of each proposal was analyzed. In addition, we did not assume that taxes would be lower for everyone, which would of course increase personal savings. Instead, we compared the different taxation methods by assuming that they would be revenue neutral.

A **consumption tax** on the individual taxes the portion of income used for consumption, where consumption equals total income plus net borrowing minus net savings.[13] It would be very similar to a **national retail sales tax,** except that taxes would probably be collected from wages and pensions in ways similar to today's income tax, whereas the sales tax is collected upon each sales transaction. Individuals would not be taxed on any portion of wages that were saved until the time when they are later withdrawn for consumption. Contributions to retirement plans would likewise not be taxed until distributed and used for consumption. Thus, there would be no special tax preference for pensions over individual savings; they would be treated exactly the same.[14] This is sometimes described as eliminating the tax preference for pensions, sometimes as extending the tax incentive to all forms of savings.

Employer contributions toward health insurance consumption could be taxable to either the employer or employee. To the extent that health insurance contributions were taxable to the employer, there might be some tax incentive if the employer tax rates were lower than the employee's consumption tax rate, which might depend on the income level of the employee. However, this tax incentive would be minor in comparison to the current tax rule under which health insurance is never taxed.

A **value-added tax** might be considered a consumption tax paid by the employer. Under a VAT system, the employer pays tax on all income. In order to avoid double taxation, a VAT system credits the employer for the taxes it pays for raw materials (or business inputs). Alternately, the VAT may offset the employer's income by the purchase prices of its business inputs. Thus, under a pure VAT, an employer is taxed on employee compensation[15] in addition to profits.[16] The VAT can be made more progressive to individuals if wages are defined as business inputs and made taxable to the employee. This variation on the pure VAT is addressed in the next section on wage tax.[17] Many countries switched to the VAT from national retail sales taxes, which were regressive and very conspicuous to the consumer. Their large national retail sales taxes were often subject to abuse, for example by individuals claiming a business exemption from retail tax.

The pure VAT treats all compensation—wages, pension contributions, and health plan contributions—identically. There would no longer be tax incentives for employers to provide benefits instead of cash wages.[18] Both would be taxable to the employer at the same rate and at the same time.

The **wage tax** on the individual taxes only the employee's

wage income, not investment income. Thus, savings would be taxed only once when received as wages, not each year as it earned interest. Columns 1 and 2 of Table 2 show that a $2,000 contribution to a pension plan would produce an after-tax distribution of $8,615 in 30 years, while $2,000 in saved wages would yield $7,186. The difference is wholly due to the fact that the pension contribution (unlike saved wages) avoids FICA taxes. If the individual is below the Social Security wage base, the Social Security benefit may be larger under column 2, sometimes enough to make up the difference. If the individual is over the Social Security wage base, FICA taxes will be smaller and the column 2 distribution will increase to $8,328, very close to the $8,615 from the pension plan. Thus, pension contributions in a wage-tax system would have a much smaller tax advantage than under the current system. It should be noted that an employer-sponsored pension plan might also have another tax advantage if the worker could get a lower marginal tax rate at retirement. For these reasons, the wage tax preserves more tax incentives for employer-sponsored pension plans than the VAT or consumption tax systems, but still has fewer incentives than the current system.

Column 3 of Table 2 shows that the FICA tax incentive is totally lost if there is a tax credit for FICA taxes. The FICA tax credit has another repercussion: Social Security and Medicare would be largely funded out of general revenues.

Under the wage tax, employer-provided health coverage could be taxable to either employer or employee. If taxable to the employee just like wages, there would be no tax incentive for the employer to purchase it.[19] The difficulty of allocating health costs to each employee might tarnish this method of taxation. The easier method would be to make health care costs nondeductible to the employer. This would also eliminate the tax advantages. There might be a small tax incentive to provide health benefits in lieu of cash wages if employer tax rates were less than the employee's.

A wage tax is similar to a consumption tax, but taxes sav-

Table 2
Effect of Wage Tax on Savings

	Qualified Pension	Personal Savings including 401(k)	Personal Savings Assuming Tax Credit for FICA
Initial Contribution	$2,000	$2,000	$2,000
Employer FICA tax[1]	- 0	-142	-142
Net Employer Contribution	$2,000	$1,858	$1,858
Employee FICA Tax	- 0	- 142	- 142
Employee Income Tax[2]	- 0	- 464	- 216[3]
Post-Tax Contribution	$2,000	$1,251	$1,500
End of year 1:			
Fund Balance[4]	$2,120	$1,326	$1,590
Tax on Investment Income[2]	- 0	- 0	- 0
Balance after taxes	$2,120	$1,326	$1,590
Tax if distributed[2]	- 530	- 0	- 0
Distribution at yr 1	$1,590	$1,326	$1,590
Distribution at yr 30[2,4]	$8,615	$7,186	$8,615
Distribution at yr 30 assuming:			
35 percent tax bracket[4]	$7,467	$6,120	$7,467
interest = 8 percent[2]	$15,094	$12,591	$15,094

[1]The FICA tax rate on the employer (ER) is 7.65 percent of wages (wages equal the employer contribution AFTER reduction for the employer FICA tax on it). Thus, wages (or net ER contribution) are $2,000 ÷ 1.0765 = $1,858. The FICA tax of 7.65 percent on the employee (EE) is reflected on a later line. For employees earning over the Social Security Wage Base, the distributions in the second column will be very close to the first column (the only difference being the 1.45 percent Medicare tax on both employer and employee).

[2]Assuming a marginal tax rate of 25 percent (federal, state, and local) on contribution, investment earnings, or distributions, as applicable. Also assumes that savings are taxed annually (i.e., not invested in stocks or a home and held until retirement).

[3]A tax credit for FICA taxes might reduce the wage tax as follows: first add back in the ER FICA tax, multiply by the tax rate (assumed to be 25 percent in this example), and then subtract the ER and EE FICA taxes, i.e. (1,858+142) x 25 percent - 142 -142 = 216. The personal savings in the third column produce the same results as the pension contributions in the first column. Thus, if the tax system has a credit for FICA taxes, the FICA incentive would no longer exist. Armey's wage tax bill would not do this. It would retain the FICA tax incentive. However, as discussed earlier in the paper, the FICA tax provides a benefit and thus is not as much an incentive as it first appears.

[4]Assuming an investment return of 6 percent per year.

ings earlier. In theory, if either a wage or consumption tax were in place over an entire lifetime, the net results would be equivalent. A 17 percent wage tax on all wages with no exemptions would be equivalent to a 17 percent consumption tax (as long as amounts received/inherited from others or given/bequeathed to others also were taxed at 17 percent).

In summary, most of the current tax reform proposals eliminate tax incentives for employer-provided health insurance and pensions. Some smaller tax incentives for employer sponsorship may remain, if:

- The FICA tax continues to tax only wages and not benefits. This has significant relevance only to employees below the wage base and may not be a real economic benefit incentive in reality because it may provide a larger Social Security benefit.
- Pension contributions are tax-deferred, but not savings, and marginal tax rates are lower at retirement.
- Benefits are taxable to the employer while wages are taxable to the employee, or
- State and local governments continue to use the current income tax system.

These tax incentives would be much smaller than those that exist today. However, other tax incentives could be added to any of the tax reform proposals.

Repercussions for Employer-Based Health Insurance

Reduced Health Insurance Coverage. It is very difficult to predict exactly what will happen under tax reform. However, most analysts suggest that the loss of the tax incentives will cause some employers to reduce or eliminate their health insurance.[20]

For example, if the employer deduction for health insurance is eliminated,[21] employers could reduce their taxes merely by switching to cash wages[22] or reducing the health plan. If employers respond by increasing costs to employees, some healthy employees may decide against coverage. Studies have shown that higher costs would decrease the demand for health care and insurance somewhat.[23,24]

Furthermore, these studies did not reflect another change due to the tax reform proposals. The cost differential between employer-purchased health insurance and employee-purchased insurance would decrease dramatically. This would give employers further reason to pay more in cash wages unless other advantages of employer-purchasing outweighed the disadvantages. Some of the other advantages are lower group rates, competitive pressures in maintaining a quality work force, social responsibility, the maintenance of a healthy work force, coverage of even poor health risks, and employee desires for the employer to handle payroll deductions and other administration. Some disadvantages that employers would happily eliminate are the administrative costs and complexity, the distraction from the corporation's primary mission, the continuous increase in regulations and court cases, the possibility of uncontrolled medical inflation, and constant problems for management to address.

Changing the current system to tax employees for employer-paid health insurance[25] would increase the nation's tax revenue, but it would also increase the employee's costs by anywhere from 15 percent to more than 50 percent[26] of the employer's contribution. This could make insurance more costly than its value to healthy employees (especially if they are in high tax brackets), who might then waive the insurance. If the employer's response is to increase the per person premium, more employees might waive insurance creating a death spiral[27] common to situations where severe adverse selection occurs. Alternatively, the employer could set premiums based on age to avoid the death spiral. In that case, older employees who were healthy might also waive their insurance, and some could not afford the coverage. If enough employees waive insurance, the advantages of group insurance would be lost (especially to small employers) and the employer might simply terminate the health plan.

Finally, under proposals where health insurance and wages were both taxable to the employer (or both taxable to the employees), the employer's tax bill would be the same whether they paid premiums or higher wages. Their wish to reduce administrative burdens and budget risks might not be strong enough to terminate the health plan, unless enough employees agreed. The employees' decision after tax reform would be different than today. Currently, if an employer drops the health plan, the employees may get a pay increase equal to the employer's contribution but they will have to pay taxes on it. Under tax reform however, employees as a group could get the *full* employer contribution in cash in exchange for dropping the health insurance. Their taxes won't change. More employees would be interested in this exchange, especially healthy, young, and single ones.

More Uninsured Americans. With all the advantages of employer-sponsored group health insurance, it is not clear

how many employers would drop their plans. However, since employers provide health insurance for most non-elderly people and only a small portion are uninsured, even a small decrease in employer health plans could cause a dramatic increase in the uninsured population.[28] This could put strains on providers already under pressure by managed care to reduce prices and the government (e.g., Medicaid), which would likely be called upon to fill the gap. Equally important, many young and healthy employees will choose not to participate. Many of the current uninsured are working poor who cannot afford health insurance without assistance. Raising costs and moving from employment-based to an individual-based system will not help them. The access of uninsured citizens to health services would probably decline unless the services were paid for in advance. Insurers and third-party administrators (TPAs) would lose business as employers eliminated or reduced their health plans. With a smaller portion of the market, insurers and TPAs would have less ability to negotiate for lower costs, as has been done very successfully lately. Employees would lose the administrative efficiencies and simplicity of the employer group plan.

The more expensive fee-for-service plans could experience a dramatic decrease in business as employees seek to reduce taxes by opting for lower-cost plans that feature higher deductibles and cover fewer services. Many employers may respond by restructuring their plans to offer lower-cost alternatives. Others might unbundle their plans, separating out supplemental coverages like dental, vision, preventive care, and AD&D (accidental death & dismemberment) so that employees could drop them. Employers and employees might go further toward catastrophic coverage, so that even the inexpensive HMOs, which are structurally and philosophically oriented toward comprehensive care, could see drastically reduced enrollment.

Advantages. There might be advantages to tax reform in the health care arena. If employees had to pay larger deductibles, coinsurance, and co-payments for their health care, and out-of-pocket for the full costs of services not covered by their employer's plan, they might become more engaged in monitoring their own health care and more efficient in the use of health services. This might reduce the over-utilization that is a cause of health-care inflation. In addition, employees would have more choice in spending their compensation. Some may not want or need health care to the extent that others do. Some argue that disassociating health insurance from employment would result in a more flexible system that would better meet consumers' needs and break the link between unemployment and a lack of insurance. Increased consumer awareness of the cost of health care and the resulting increased competition could force many providers to reduce charges and become more efficient. Premiums would be lower for young individuals and higher for older individuals. This might be seen as an advantage since income tends to rise with age during the working years.

Disadvantages. The movement to less insurance could lead to widespread under-insurance and raise the cost to society of uncompensated care. Significantly reduced participation by young and healthy employees will increase costs for older and sicker individuals. This is particularly a problem for the unhealthy and early retirees, whose incomes may also be reduced. Employees (particularly those who choose not to buy insurance) might avoid important preventive care, causing larger costs in the future. They also might not get the second opinions required by managed care plans and go ahead with unnecessary and over-priced procedures. Insurers and third-party administrators would have less ability to demand lower charges from the providers if they were a smaller force in the market. The trend toward managed care might slow considerably if individuals, not employers, were deciding whether to purchase the insurance. Thus, it is not clear that tax reform would reduce health care costs, by moving payment from employers to employees. Such a dramatic change in tax policy deserves extensive study and high visibility in the public debate.

The effect on managed care isn't clear. Greater consumer price sensitivity might encourage it. On the other hand, employers have been an important catalyst. Also, network based managed care appears to be less compatible with reduced coverage levels.

Repercussions for Employer-Sponsored Pensions

Fewer Pensions. As mentioned above, the tax reform proposals greatly reduce (and sometimes eliminate) tax advantages for employer-sponsored plans. Without clear tax advantages, many small employers have indicated they would drop their pension plans. Small business owners provide plans primarily for the tax advantages, which generally exceed administrative costs and sometimes even the cost of their employees' benefits. Larger employers may eventually follow if their competitors in the labor market were offering higher wages instead of pensions or their employees wanted more cash without the restrictions on in-service withdrawals and excise taxes. Pension plans would be terminated and replaced by non-qualified plans, which would also avoid taxation on earnings, yet have very few rules, and might benefit only a select group of employees chosen by the employer. Many 401(k) plans would be terminated or would become payroll deduction plans to avoid the non-discrimination and other rules. Employers that terminated plans could pass on the savings in higher cash wages to mollify workers. The effects on employers, employees, government, and unions are addressed below.

Employers. Some employers will keep pension plans because of advantages that include:

- Allowing employers to retire older employees with dignity and promote younger employees.
- Helping employers recruit and retain key employees.
- Satisfying union demands.
- Helping employers downsize and become more competitive through early retirement subsidies and windows.
- Permitting employers to increase pensions immediately and make valuable promises to employees without having to fund for them immediately.
- Removing the investment risk, longevity risk, inflation risk, early retirement risk, and disability risk from individual employees, which may increase their productivity (because they will have less to worry about).
- Obtaining better investment returns because employer plans are better able to obtain higher returns than individuals who generally invest more conservatively.[29]
- Spreading administrative costs over many employees, and thus being more efficient than the employee.

Even with all these advantages, it wasn't until tax advantages became substantial in the 1940s that pensions became popular. This implies that tax incentives may be the primary motivator for employers to have pension plans. Some people disagree, pointing out that pension plans existed before the larger tax advantages of the 1940s. However, those pension plans were nothing like the ERISA plans of today. Without all the current rules:

- pension plans were often not well-funded,
- benefits were discretionary and often payable only to a select group of employees,
- employees had to work until age 65 to get the pension,
- pensions often had no benefit rights for widowed, divorced, or separated spouses, and
- benefits could be taken away at the employer's whim, or due to either underfunding or to employees leaving to go to competitors.

Thus, the existence of plans before the 1940s does not prove that employers will keep their current ERISA-qualified pension plans after tax reform. Employers will not want to meet all the requirements of today's pension plans without tax advantages.

Employees. Proponents of tax reform suggest that people will save more if savings is no longer discouraged by taxation. In addition, if employers terminate their plans, employees will save more because they can't rely on someone else to do it. However, employees often don't appreciate how much their employer was contributing for them. They may not save as much, especially lower-paid employees. Employees also might be more likely to withdraw from their savings for more immediate needs over the less immediate needs of retirement. A recent Current Population Survey showed that less than one-fourth of terminating workers rolled their lump-sum pension payment into another tax-sheltered retirement plan or IRA[30] This is indicative of workers' desire for cash today instead of savings or a pension plan. Many individuals will not or cannot save enough for retirement and often will need to withdraw their savings to spend before retirement.

Government, realizing that it no longer has any leverage to regulate plans, might eliminate most of its pension laws. Without non-discrimination and coverage rules, plans might not benefit all employees. If excise taxes on early withdrawals were removed to encourage pension contributions, massive amounts from the current $5 trillion in tax-qualified money would be accessible for immediate cashout. Current contributions would not stay saved. Reduced regulations, however, will not be enough for most employers to keep their pension plans. Only the total elimination of all regulations would encourage retention of pension plans, but then they wouldn't have the advantages of today's plans for the employees and the nation.

Unions, acting in their employees' interests, will push for employers to maintain their existing pension plans. But unions are not as influential as they once were, particularly in the private sector, and they may not be strong enough to stem

the tide. They may also find their membership pushing for cash over pensions, especially the lower-paid members who need cash. However, many years from now, after most plans have been terminated and many workers are not prepared for retirement, unions may come back strong with the message that pension plans need to be reinstituted. On the other hand, unions might set up portable TIAA-CREF type pension plans (also similar to the portable 401(k)s set up by the United Mine Workers) and encourage their membership to save right along with their membership dues or through payroll deductions. This way they could take advantage of group efficiencies. Whether union members would choose to participate in the absence of clear tax advantages over regular savings would be an open question.

Reduced Retirement Security for Lower-Paid Workers. Under the tax proposals, savings would likely become more skewed than they are currently. Employer-sponsored plans are broad-based and generally include young and old, low-paid and high-paid, and full-time workers as well as some part-time workers. Individuals, particularly the young and lower-paid ones, will not save as much as their employers were saving for them. This can be seen by looking at their low participation rates in IRAs. Proponents note that some of the tax proposals will reduce taxes of low-income people to zero, thus enabling them to save more. However, statistics show that low-income people actually consume more than their gross earnings. Thus, they probably will not be able to save enough for retirement.

Increased Individual Risks. Switching from employer plans to individual savings moves more risks (e.g., investment risk, longevity risk, early retirement risk, inflation risk) from the employer group onto the individual. This could parallel the risks associated with a partial privatization of Social Security, which also would shift more risks from the nation onto the individual.

Disadvantages for the Nation. The problem of inadequate retirement income among a large segment of the population will not be seen immediately because the current group of people near retirement have had employer plans for most of their working careers. The problems will show up, however, as the baby-boom population starts to retire. A large segment of that population will not have adequate pensions and will not have saved enough to make up the difference. This will take decades to rectify, because adequate funds cannot be built up quickly. Thus, there will be a long period during which elderly people will have to work, have a low standard of living, or require assistance. Assuming some elderly individuals will be unable to continue working and will require assistance, the succeeding generation of taxpayers will have to bear the burden. In addition, more pressure will be placed on Social Security at the very time the system is projected to go insolvent.

In addition, many advantages to the individual and the nation of group saving through the employer may be lost. In particular, employer pensions have a huge pool of money that is invested very efficiently in higher-risk investments that help the national economy be more productive. Individuals often invest in conservative instruments that are not as beneficial for the national economy. Thus, tax reform could end up encouraging inefficient markets, which is not a goal of any tax system.

Advantages. Some advantages will appear immediately. The tax base will be broadened and tax rates can go down. Also, people currently without pensions will no longer pay for other people's tax incentives. Individuals will see lower taxes, and some might save more.

Without pension plans, workers will not be locked into their jobs by the golden handcuffs of the pension plan.[31] They will be able to access their savings without having to quit or retire. Employers will get immediate relief from reduced pension regulations. Without the responsibilities of a pension plan, employers can focus more on their real corporate goals. Individuals will become more responsible for their retirement, and will save at their own discretion. Some people will legitimately decide they do not need to save for retirement (e.g., those who do not expect to live long, those who have children who will take care of them in retirement, those who don't want to stop working). People will use their money as they see fit and therefore will be more independent.

National Savings May Not Increase. Higher-income workers already save by using tax advantages identical to those of the wage tax through investments in tax-deferred annuities, tax-exempt bonds, a home, or securities. Thus, the highly paid may not be motivated to save more under a wage tax. Under a consumption tax, however, they would get an immediate deduction for saving money, and thus perhaps a stronger psychological incentive to save.[32] It is possible that their savings may not increase much, however, because the only way to increase their savings is to decrease their consumption. If someone's taxes are reduced under tax reform, the individual will be able to save more, but those who have tax increases under reform will probably save less. Also, low-wage earners may continue to consume more than they earn, as current statistics show, and may not be able to save more. It is also possible that large amounts of the $5 trillion already saved in retirement plans now would be spent when pension plans are terminated, thus decreasing savings. Other non-pension investments with large unrealized appreciation might also be sold since the gain would no longer be taxed. Whether the total amount would be reinvested until retirement or whether some would be used for consumption, could greatly affect national savings.

Finally, most individuals covered by defined-benefit plans do not realize how much their employer contributes to their retirement plans. Lower-paid employees are especially unlikely to save as much as their employer currently contributes. Thus, it is not clear that these proposals will increase national savings,[33] which is one of the primary goals of tax reform.

Complex Transition. Switching from an income tax to consumption tax will mean that people's personal savings, which have been taxed already, would be taxed again when spent.

This could significantly increase the tax burden on the elderly who currently don't pay taxes when they spend their already-taxed savings. Thus, switching to a consumption tax on individuals would dramatically increase taxes on the elderly. Although less obvious, a pure VAT system might have the same result. A transition rule could provide relief to the elderly, but would be complex and costly. Individuals might have to report their total non-qualified savings to the government in order to get these special dollars forever exempted from taxation. Large-scale spending of these tax-exempt funds would greatly reduce tax revenues in the early years and might hurt the total investment in the economy. If a time limit were put on the tax exemption, the special dollars would be spent even faster, accentuating the drain on national savings. A wage tax reduces at least the appearance of this problem, but the elderly still would be paying taxes (when they consumed). Consumption taxes are much easier to implement in countries that formerly had national sales taxes.

Annuities and Life Insurance Products

Annuities and certain life insurance products are also tax-favored: their inside buildup of assets is tax-deferred, while mutual funds and other savings products do not enjoy this feature. Under tax reform, all savings would be treated like annuities. The consumer appeal of interest-sensitive insurance products such as annuities and variable life products could suffer a substantial decline in a tax system where all investment income is free from taxation. Insurance products might need to guarantee higher rates of return to remain competitive. If the life insurance industry cannot be competitive on the investment portion of their contracts, it may have to shift to pure-risk term insurance products. This could reduce interest in insurance of any kind, especially by older individuals for whom term insurance premiums are expensive. Insurers could lose a good deal of business from tax reform. On the other hand, focusing the insurance purchasing strategy on risk management rather than investment strategy might ultimately have advantages for both the consumer and the industry.

Most tax reform proposals do not specifically address how to tax the proceeds from life insurance. One option, common in many countries, would be to treat these proceeds as investment income and similarly exclude them from taxation. Since the current system excludes life insurance death benefits from income, any new definition of income must consider how these should be treated.

The current incentives were created because life insurance and annuities were considered an important social good. If incentives are reduced or eliminated, resulting in less coverage, thought must be given to what public or private sources will be available to fill the gap. If Congress finds that many people are not adequately covered for early death or unusual longevity in retirement, it may decide to reinstitute incentives for life insurance and annuities. Incentives may be less expensive than providing more welfare for widows and retirees who have outlived their savings.

Conclusions and Alternatives

Although employer-provided pensions and health insurance have many advantages emanating from their group nature, they would face serious decline under the current tax reform proposals. This is true for the consumption, VAT, and wage tax reforms as currently proposed, and for any proposal that drastically reduces, eliminates, or negates the special tax incentives for employer-sponsored pension and health plans from the current tax system.

Some proponents state that the consumption tax system retains tax incentives for employer-sponsored pensions, but this is not accurate. Current tax preferences for employer-sponsored plans simply would become irrelevant because the consumption tax proposals provide tax-favored status to all savings. Pension plans would be terminated in favor of higher cash wages or non-qualified plans.

If employer health and retirement plans are reduced, it is likely that some employees will not fill the gaps, especially lower paid and young employees. Even if employer health coverage decreases only a little, the number of uninsured and underinsured Americans could increase dramatically, imposing difficult burdens on individuals, providers, and government programs. Inadequate retirement income will become further skewed against low-paid workers and will hit us at the same time the baby boomers also need more from Social Security. In addition, national savings may not increase as suggested by proponents, nor would it be invested as efficiently as today's pension funds.

The proposals could be helpful by simplifying the tax code, reducing tax rates, reducing inflationary pressures on health care costs, reducing government regulation of our lives, freeing up businesses to focus on their primary mission, and making people more independent and responsible for themselves. The tax code would be less likely to distort economic decision making and might result in a more efficient allocation of our resources. The hoped-for efficiencies may depend on whether individuals, in the absence of incentives, will truly make decisions that are in their long-term best interest and whether individually optimal decisions are best for society as a whole.

If individuals fail to provide adequate health insurance and retirement income for themselves, government—or families—would have to fill the health care and retirement gaps, which could cost more than the incentives that were eliminated. Ironically, government's response might be to mandate *employer* health and pension plans,[34] which is the exact opposite of proponents' desire for more freedom of choice. Alternately, government might place mandates on *individuals,* but given the administrative and political difficulties involved, this seems unlikely. A final alternative would be a *government*-sponsored universal coverage program. This would address the issues of risk spreading, high individual policy administrative costs and the uninsured problem, but it comes with its own set of problems, and has historically been rejected by the U.S. political system. If tax reform is desirable, then discussions should be held on whether employers, individuals, or the government is the best entity to solve the retirement and health coverage problem in our country. A key policy question is whether the benefits of tax reform outweigh the costs. Will increased tax revenues and increased efficiencies cover the costs of providing for those who lose the protections of the voluntary employment-based benefit system.

The advantages of tax reform to areas outside employee benefits is outside the scope of this report. However, if the advantages of the employee benefit system are judged to outweigh the costs, several options exist that allow progress toward the goals of tax reform without eliminating the tax advantages needed to maintain adequate health care and retirement incomes in this country.

For example, Congress could act in an incremental way by retaining some tax advantages. Employers could receive a deduction—60 percent, perhaps—of their health insurance costs, under any of the proposed tax systems.[35] The deduction could be phased-in gradually to ascertain the effects along the way. In addition, employer health costs could remain exempt from FICA taxes[36] (or at least 60 percent of the FICA tax or at least the employee portion). Pension plans could receive a tax credit and continue to receive the FICA exemption. In addition, Congress could increase maximum pension limits and the Social Security wage base and simplify pension rules. The last three changes would affect the employer's decision-makers directly and increase their interest in maintaining pension plans.

Similarly, Congress could provide greater incentives to individual savings, but not eliminate the relative tax advantage of pension plans. This could be accomplished by taxing investment income at a lower tax rate or taxing only amounts above a certain threshold, perhaps $10,000. Alternatively, Congress could allow tax-deductible contributions to IRAs from individuals with incomes over the current low levels or by increasing allowable contributions to an IRA. Furthermore, instead of tax deductions, which vary by the income level of the contributor, IRAs could receive tax credits. This would give lower-income people more tax incentives to invest in IRAs, which is where savings need to be increased. The amount of tax incentives could be set such that the cost of the tax expenditure would be less than its benefits to the nation.

Congress also should consider increasing the excise taxes on early withdrawals from pension plans, so that these monies are used for the purposes for which they got the tax advantages. Studies indicate that the current 10 percent excise tax is not enough of a deterrent. An increased excise tax would increase both national savings and tax revenue.

The loss of employer-sponsored pensions does not have to happen. Many of the advantages that reformers seek can be achieved without the disadvantages, as long as adequate tax incentives still exist for employer-sponsored plans. Many tax reformers fear that allowing tax incentives in one area, will open the door to all the other incentives and loopholes that currently exist. Congress will have to decide on a case-by-case basis whether the advantages of tax incentives outweigh the costs.

The Academy encourages further discussion of these issues. Elected officials should seek a tax system that achieves the goals of reform and provides adequate incentives for broad-based pension and health coverage.

Endnotes

1. Revenue lost to the federal government on pension contributions and earnings is $70 billion per year, according to the Joint Committee on Taxation. However, much of this amount represents deferrals and will be recovered in future years when benefits are received. The exemption of employer-paid health premiums from taxation also costs the government about $50 billion per year.

2. This is the case for medical, dental, and vision benefits. The rules for disability benefits are different. Disability income benefits are taxable if the employer deducts the premiums. If the employee pays the premium, it is with after-tax dollars, but the benefit is tax-free. In other words, either the premiums or the benefits of disability income will be taxed.

3. Taxpayers who itemize may deduct health expenses (including premiums), but only for amounts in excess of 7.5 percent of adjusted gross income. Self-employed individuals may deduct 30 percent of health insurance premiums in 1996. A recent law increases the deduction gradually over 10 years to 80 percent in 2006.

4. Marginal federal taxes can be reduced due to increases in state taxes (which are deductible) and can be increased for phase-outs of exemptions and deductions.

5. Employees can also escape immediate taxation on their own retirement contributions through 401(k) cash or deferred arrangements, 403(b) tax-sheltered annuities, and IRAs. They can also purchase tax-deferred annuities or tax-exempt bonds. However, the returns on these securities are often lower, thus offsetting the advantages of tax deferral or tax exemption. Annual taxation of investment returns also can be deferred through holding on to stocks, homes, etc.

6. This represents about 77 percent of the non-elderly in families headed by a full-time, permanent worker and 90 percent of the non-elderly with private insurance. Source: March 1996 Supplement to Current Population Survey.

7. Adverse selection occurs when individuals make choices based on their own best interests that are contrary to the interests of the insurance pool. For example, healthy individuals may not purchase health insurance unless it is substantially subsidized by another party (e.g., their employer or the government), because they can pay for the medical services directly on their own at lower cost.

8. Managed care has been helpful in reducing utilization and prices—to the detriment of needed care, according to some critics. In addition, medical savings accounts (MSAs) may reduce costs by allowing employees to pay for certain benefits outside the health plan with tax-advantaged dollars. By allowing employees to keep unspent funds, MSAs discourage overutilization of health services. However, because MSAs are available only with high-deductible catastrophic coverage, costs will increase for less healthy employees.

9. Other advantages are listed in the section addressing employer termination of pension plans due to tax reform.

10. Defined benefit (DB) plans are retirement plans that specify benefit amounts usually as a percentage of workers' final three- or five-year salary average. Defined contribution (DC) plans and 401(k) plans define how much is contributed for each worker per year.

11. Some employers solve this concern by switching to DC or account-based DB plans.

12. However, pension funds are taxed when distributed.

13. This may be difficult to determine on one's tax form.

14. The immediate FICA tax incentive would still exist if wages but not employee benefits were taxed. The incentive is less significant above the Social Security wage base. It would also be smaller than current tax incentives. Furthermore, as discussed earlier, avoiding the FICA tax may not really be a tax incentive for some people because it can provide a Social Security benefit of about the same value as the tax. Even for people who receive Social Security benefits that are less valuable than their FICA tax, the small FICA tax incentive could be lost if the employer-provided benefits are taxed by FICA. This is not unreasonable, especially the employer portion of the FICA tax (which wouldn't need to be allocated if the wage base limit was eliminated). It would help Social Security by expanding its taxable base. Thus, all tax incentives could be lost to everyone. Another way to lose the FICA tax advantage is to allow a credit for FICA taxes, which the Nunn-Domenici USA Tax proposal from the 104th Congress would do. This essentially undoes the FICA incentive. It has another repercussion — Social Security and Medicare would essentially be funded out of general revenues.

15. The tax on employee compensation for nonprofits and governments could be paid by employees or picked up by the employer.

16. Thus, a VAT encourages capital expenditures over labor expenditures. At the end of the fiscal year, businesses can reduce their tax base dollar-for-dollar for each capital purchase, but not for labor expenditures. This does not mean that capital expenditures were never taxed, however. The tax was embedded in their purchase price.

17. This variation on the pure VAT was in Rep. Armey's flat tax proposal. The plan was described as flat because both the employer VAT percentage and the employee tax rate are a flat 17 percent after a transition period. This can be progressive through the use of standard deductions, which are part of the Armey proposal. Armey's proposal also would simplify pension rules by repealing the section 415 limits and the nondiscrimination rules. Worker protection provisions on participation, vesting, funding, fiduciary rules, distribution, and exclusive benefits would be preserved.

18. See endnote 14.

19. See endnote 14.

20. Small employers are more likely to drop their coverage in the short run. Providing health insurance is already a struggle for them. The benefits are more administratively burdensome, the escalating costs are more unpredictable, and insurers often impose minimum participation requirements (e.g., 75 percent), which if unmet means they have to purchase individually underwritten health insurance policies, thus losing the group advantages. Some employers are already dropping their health plans. Eliminating the current tax incentives will accelerate this trend.

21. Rep. Gephardt's proposal suggests this.

22. Switching to paying cash wages may not be so easy. If the employer increases everyone's pay by the same amount, then about half the employees will not get enough to replace their insurance (except where states mandate community rating). If the wage increase reflects an employee's age, sex, family status, and health status, then employees in similar jobs could complain about inequitable pay levels. There is no easy way out of this dilemma. Cafeteria or flexible benefit plans can help by allowing employees to choose what benefits they want, but may have similar problems.

23. James M. Poterba (National Bureau of Economic Research and MIT economist) suggests that health coverage would decrease by 6 to 8 percent and employer contributions to health plans would decrease by 12 to 38 percent in "The Impact of Fundamental Tax Reform on Employer-Provided Health Insurance" (1996).

24. Stephen Woodbury (Michigan State University economics professor and W. E. Upjohn Institute for Employment Research) suggests health coverage would decrease 2 percent and employer contributions by about 15 percent in his 1996 paper entitled "Employee Benefits and Tax Reform." He also suggests pension coverage will drop by 5 percent and employer contributions by 40 to 50 percent.

25. It is much easier in practice to make health insurance taxable to the employer. If taxable to employees, then an individual allocation must occur. Simply imputing the same amount to each employee would be unfair to young, single, and healthy employees. A more exacting method would be quite complex and always subject to criticism.

26. Over 50 percent is possible for middle-income employees earning just under the Social Security wage base (assuming health insurance premiums were considered wages subject to the FICA tax) and high-income employees in states with income taxes.

27. The death spiral occurs in a voluntary system when individuals with significantly different expected costs are charged the same premium. Premiums spiral upwards without end, continually pricing out lower risks so that the insurance is worthwhile only to more expensive, higher-risk people. The spiral continues until no one can afford to pay the premium costs.

28. This assumes that many employees will not get adequate coverage on their own or through their spouse's employer or another organization.

29. Repeated studies have shown that workers invest more conservatively and earn about 200 fewer basis points than their employer's plan. For a contribution made at age 30 and invested until retirement at age 65, this translates into an accumulation that is 50 percent lower. Some individuals are even more risk averse, such as workers with small savings who are afraid to lose any principal. Other individuals invest more aggressively, but generally become more risk averse when they must start liquidating their savings for consumption purposes. An ongoing pension with a steady inflow of new employees does not have this concern.

30. Low levels of rollovers could partly be due to increased financial needs at the time of termination, or the impact of the amount available, whether very small or very large. Often pension plans are seen by employees as savings vehicles, not retirement plans. On the other hand, it should be noted that very few people with the option to save through tax deductible IRAs actually use them. The participation rates under 401(k) plans are higher, however, but this is due to matching contributions, strong employer encouragement, and the ability to borrow from them immediately.

31. See endnote 11.

32. A counter example might be Japan which has one of the highest national savings rates even though consumption taxes account for only a small percentage of its tax revenue.

33. A paper by Andrew A. Samwick, "The Effects of Tax Reform on Pension Saving and Nonpension Saving," presented at the American Enterprise Institute on October 25, 1996, states that the likely effect of tax reform would be to lower the private saving of many households that are currently covered by pensions. Samwick explains that pension plans force greater savings than families would otherwise save for retirement. A paper by Eric M. Engen (Federal Reserve Board) and William G. Gale (Brookings Institution), titled "Comprehensive Tax Reform and the Private Pension System" (April 1996), states that the reduction in pension saving could substantially or completely offset any induced increase in non-pension saving. The authors also state that tax reform would shrink, but not eliminate, pension coverage. However, these economic studies cited analyze only the changes due to changing tax rates and do not reflect the fact that savings will have the same tax incentives as pensions after tax reform. Thus, the drop in pension coverage will probably be greater than their models predict.

34. For example, Social Security is a mandate on employers. Also witness the current privatization proposals for mandatory savings accounts to accompany a smaller Social Security. Will this mandate on individuals be enacted?

35. The Nunn-Domenici bill (S. 722) contains deductions for mortgage interest, charitable contributions, and tuition for education and training.

36. Continuing the exemption of employer-sponsored health and pension plans from FICA taxes will not alone provide enough incentive. FICA taxes may purchase a benefit of about the same value for many people, and the FICA tax rate is smaller than current marginal tax rates that include FICA. Also, the FICA exemption may not have much impact on decision-making. For example, many employers prefer 401(k) plans to pension plans, even though 401(k)s do not get the FICA exemption. Perhaps this is because 401(k)s are less costly to employers. In addition, the FICA exemption has very little value to decision-making management whose wages are generally above the Social Security wage base, where the tax rate drops to 1.45 percent for both employee and employer.

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