TAX REFORM

IMPLICATIONS FOR ECONOMIC SECURITY AND EMPLOYEE BENEFITS

EDITED BY
DALLAS L. SALISBURY

Education and Research Fund
2121 K Street, NW, Suite 600
Washington, DC 20037-1896
(202) 659-0670
web site www.ebri.org

Library of Congress Cataloging-in-Publication Data

Tax reform : implications for economic security and employee benefits. p. cm.
Includes bibliographical references.
ISBN 0-86643-086-5
1. Employee fringe benefits—Taxation—United States. 2. Pension trusts—Taxation—United States. 3. Deferred compensation—Taxation—United States. 4. Insurance, Health—Taxation—United States. I. Employee Benefit Research Institute (Washington, D.C.)
HJ4653.F7T39 1997
336. 24'15—DC21

96–37846
CIP

Table of Contents

TABLES

Preface

Tax policy is at the core of the provision of employee benefits, which currently enhance the economic security of over 200 million Americans.

The dramatic growth of employee benefits—particularly pensions—can be traced to the period immediately following World War Two. During a time of wage controls, benefits offered a means of providing increased total compensation, on a tax-effective basis. The tax-exempt treatment of health benefits expanded with the Revenue Act of 1954, and group health plans grew rapidly. More recent years have seen the explosive growth of the defined contribution retirement plan, made possible by new provisions of the Revenue Act of 1978 and driven by workers' new ability to contribute pretax dollars and perhaps receive a tax-deferred employer match as well.

A recent survey conducted by the Employee Benefit Research Institute (EBRI) and the Gallup Organization, Inc., found that 64 percent of respondents would no longer contribute to an employment-based retirement plan if the tax advantage was lost; 36 percent would want their employer to give them more salary rather than contribute to a pension plan that provides no tax deferral. Over 80 percent said they would want health benefits regardless of the tax treatment.

The special tax treatment of benefits has come under scrutiny for many reasons over the years, with recent debates dominated by the following arguments:

- There should be no tax preferences in the absence of a mandate that all workers receive identical treatment and benefits. This philosophy contends that it is unfair for some, but not all, workers to have health, pension, and other benefits.
- The tax preference should go to each individual. This philosophy contends that, regardless of whether or not individuals work, or work for an employer or for themselves, they should have the same opportunities. This argument often further suggests that the tax advantage should go directly to the individual and should not require any employer or union involvement.
- The tax benefits should be targeted to low and middle income taxpayers, with limited or no tax incentives for higher income workers. This philosophy has resulted in income limits on 401(k), individual retirement account, and other retirement plans, so that only low income individuals receive full tax incentives. It has also produced suggestions for an income test on health insurance tax incentives.
- There should be no tax preferences for employee benefits. This philosophy holds that tax law should not be used to affect behavior.

Beginning in 1979, EBRI has held policy forums and round tables to bring together public policymakers, corporate executives, financial planners, and representatives from labor, academia, and research organizations to discuss major policy areas that affect Americans' economic security. Over 100 of these sessions have now been held. "Tax Reform: Implications for Economic Security and Employee Benefits," proved to be a stimulating session that produced a number of excellent papers and commentaries. Whether tax reform is radical or marginal, if it affects health and retirement programs, it affects over 200 million Americans and their economic security.

I thank the members of the Institute for making the policy forum possible. They provide general funding for the EBRI Education and Research Fund's mission of "telling it like it is" and presenting the facts "whatever they may be." As a result, the papers contained in this volume come from multiple perspectives, make many points that will be controversial, and agree on only one overall point: the end of tax incentives would reduce health insurance coverage and pension provision. The authors express widely different views on whether the change would be good or bad for the nation and for individuals.

The book begins with an overview essay on tax reform and employee benefits. It moves next to presentations of labor, employer, consultant, actuary, and lawyer practitioner perspectives. Papers follow on the issues of tax treatment of employee benefits, move to specific discussion of retirement programs, and then to health programs. It is interesting to note that whether the authors favor or oppose current tax incentives, they all agree that their elimination would lead to a reduction in the number of Americans with health insurance and retirement income protection from pensions.

The publication of this book allows EBRI-ERF to share the policy forum results with a broad audience. I thank all the participants and the members of the EBRI team who made the policy forum and the book possible.

The views expressed in this volume are those of the authors and should not be ascribed to the officers, trustees, members, or other sponsors of the Employee Benefit Research Institute, the EBRI Education and Research Fund, or their staffs. Nothing herein is to be construed as an attempt to aid or hinder the adoption of any pending legislation, regulation, or interpretative rule, or as legal, accounting, actuarial, or other such professional advice.

I invite your comments on the contents of the book and your suggestions for projects we should undertake in the future. I invite you to review our overall activities and publications at EBRI online (http://ebri.org).

Dallas L. Salisbury
President, EBRI
January 1997

About the Presenters and Discussants

Giles C. Archibald is a managing director and the head of international consulting in the United States for William M. Mercer, Incorporated, in New York. He is an expert on multinational pooling, the effect of the Financial Accounting Standards Board's Statement 87, and International Revenue Service 404A regulations and on the international benefit issues relating to mergers and acquisitions. Mr. Archibald joined Metropolitan Pensions Association in 1977. Formerly head of Mercer-MPA's international consulting office in London, he spent three years in the European office in Brussels and four years in London before coming to the United States in 1984. Mr. Archibald is a 1973 honors graduate of St. Andrews University in Scotland, with a degree in mathematics, and is a fellow of the Faculty of Actuaries (UK) and an Associate of the Society of Actuaries.

David S. Blitzstein is the director of the United Food and Commercial Workers International Union (UFCW) Office of Negotiated Benefits, which operates as part of the Union's Field Services Department. The office advises UFCW local unions in collective bargaining on pension and health insurance issues and is involved in strategic planning with the goal of preparing the UFCW for the benefit issues of the 21st century. In addition, Mr. Blitzstein acts as an advisor to the union's 150 jointly trusteed health and welfare and pension plans nationwide and is a trustee of the $2.0 billion UFCW Industry Pension Fund. Mr. Blitzstein is also involved in legislative policy as it relates to employee benefits and is a member of the working committee of the National Coordinating Committee for Multiemployer Plans (NCCMP). Previously, Mr. Blitzstein served as the director of corporate strategies for the United Mine Workers of America. Mr. Blitzstein is a graduate of the University of Pennsylvania and holds a master of science degree in labor studies from the University of Massachusetts in Amherst.

Gerald E. Cole, Jr., joined Milliman and Robertson, Inc., in 1988, as special counsel for employee benefits research. Mr. Cole advises M&R consultants throughout the country on a broad range of topics, including funding standards; new regulations and legislation; IRS nondiscrimination rules; plan qualification issues; mergers and transfers; withdrawal liability matters; and design and compliance considerations for VEBAs and cafeteria plans. Mr. Cole's career includes employment with the United Mine Workers of America Health and Retirement Funds, the Pension Benefit Guaranty Corporation, The Equitable Life Assurance Society of the United States, the U.S. Department of the Treasury, the Cost of Living Council, and a law firm specializing in labor relations. Mr. Cole earned his undergraduate degree with honors from the Wharton School of the University of Pennsylvania and in 1968 was awarded a LL.B. from the Harvard University Law School.

David Cutler is a John L. Loeb associate professor of social sciences at Harvard University. Mr. Cutler is also a faculty research fellow in the public economics and aging and health care programs at the National Bureau of Economic Research. His research is concentrated in public economics, particularly the economics of health care and social policy. Mr. Cutler's current work is in several areas, including explanations for increasing health costs; the labor market implications of rising health insurance costs; and market failures in small group health insurance markets. During 1993, Mr. Cutler was on leave as senior staff economist at the Council of Economic Advisers and director of the National Economic Council in the Clinton Administration. His primary responsibilities were in helping to design the president's health reform plan. Mr. Cutler received a B.A., *summa cum laude*, from Harvard College, and a Ph.D. in economics from MIT.

Stephen J. Entin is currently resident scholar at the Institute for Research on the Economics of Taxation (IRET), a pro-free market economic policy research organization based in Washington, D.C. He advised the National Commission on Economic Growth and Tax Reform (the Kemp Commission), assisted in the drafting of the commission's report, and was the author of several of its support documents. A former deputy assistant secretary for economic policy at the U.S. Department of the Treasury, he participated in the preparation of economic forecasts for the President's budgets and the development of the 1981 tax cuts, including the "tax indexing" provision that keeps tax rates from rising due to inflation. He represented the Treasury Department in the preparation of the annual reports of the Board of Trustees of the Social Security system and conducted research into the long-term outlook for the system. Prior to joining Treasury, he was a staff economist with the Joint Economic Committee of the Congress. He is a graduate of Dartmouth College and received his graduate training in economics at the University of Chicago, majoring in macroeconomics, monetary policy, and international economics.

Jonathan B. Forman has been a faculty member at the University of Oklahoma College of Law since 1985, where he teaches tax, pension, and welfare law courses. Previously, he served in all three branches of the federal government; as tax counsel to U.S. Sen. Daniel Patrick Moynihan (1983–1984); as a trial attorney for the U.S. Department of Justice, Tax Division, Northern Civil Trial Region (1979–1983); and as a judicial clerk for Judge Robert J. Yock of the U.S. Claims Court (1978–1979). Professor Forman received his J.D. from the University of Michigan School of Law in 1978 and has an M.A. in economics from George Washington University and an M.A. in psychology from the University of Iowa. Professor Forman is admitted to practice in the District of Columbia, and he is active in the American Bar Association section of taxation. He is also a fellow of the American College of Tax Counsel and a fellows program associate of the Employee Benefit Research Institute-Education and Research Fund (EBRI-ERF) Fellows Program.

William Gale is a senior fellow and the Joseph A. Pechman fellow in the economic studies program at The Brookings Institution. His areas of expertise include the budget, fiscal and tax policy, capital formation, federal credit programs, intergenerational transfers, and Social Security. Before joining Brookings, Gale was an assistant professor in the Department of Economics at the University of California at Los Angeles. In addition, he is a former senior staff economist for the Council of Economic Advisers and a former consultant for the General Accounting Office and The World Bank. Gale is currently working (with Henry Aaron) on a manuscript entitled *A Citizen's Guide to Fundamental Tax Reform,* to be published by Brookings in 1996. He has received grants from the National Institute on Aging, the National Science Foundation, the Institute for Research on Poverty at the University of Wisconsin, and the Center for American Politics and Public Policy at the University of California at Los Angeles. Graduating magna cum laude, Gale received his B.A. in economics from Duke University and later received his Ph.D. in economics from Stanford University. He also studied for a year at the London School of Economics.

Michael Graetz has been a professor at Yale since 1983, prior to that, he was a professor of law at the University of Virginia and the University of Southern California law schools and professor of law and social sciences at the California Institute of Technology. His publications on the subject of federal taxation include a leading law school text and more than 40 articles on a wide range of tax and health policy and tax compliance issues in books and scholarly journals. His new book, *The Decline–and Fall?– of the Income Tax,* is forthcoming this summer from W.W. Norton & Co. During January–June 1992, Mr. Graetz served as assistant to the secretary and special counsel at the U.S. Treasury Department; in 1990 and 1991, he served as treasury deputy assistant secretary for tax policy. In 1989, Mr. Graetz served on the Commissioner's Advisory Group of the Internal Revenue Service. During 1969–1972, he served in the U.S. Treasury Department in the Office of Tax Legislative Counsel.

Daniel Halperin is a professor at Georgetown University Law Center. He served in the Office of the Assistant Secretary for Tax Policy in the U.S. Department of the Treasury for seven years and was deputy assistant secretary from 1978 to 1980. Previously, he was a professor at the University of Pennsylvania Law School, a visiting professor at Yale and Harvard Law Schools, and an associate of Kaye, Scholer, Fierman, Hays & Handler in New York. He has written numerous articles, including "Special Tax Treatment for Employer-Based Retirement Programs: Is It 'Still' Viable as a Means of Increasing Retirement Income? Should It Continue?" He also wrote Tax Pol*icy & Retirement Income: A National Model for the 21st Century.* Mr. Halperin received his J.D. from the Harvard University Law School.

Randolf Hurst Hardock is a partner at Davis & Harman. Mr. Hardock concentrates on tax and ERISA issues relating to qualified retirement plans, executive compensation arrangements, health and other welfare benefit plans, employee stock ownership plans, tax-exempt finance, and insurance. From 1993 to 1995, Mr. Hardock served as benefits tax counsel, U.S. Department of the Treasury. He led the Treasury Department efforts on the Retirement Protection Act of 1994, which was enacted as part of the Uruguay Round Agreements Act (GATT) and, more recently, was instrumental in designing the administration's proposals relating to expanded individual retirement accounts and pension simplification. From 1986 to 1993, he was tax counsel to the U.S. Senate Committee on Finance, serving as an advisor to Chairman Lloyd Bentsen. Prior to entering public service, Mr. Hardock practiced law in Washington, DC, concentrating on employee benefits and tax-exempt finance. Mr. Hardock received his B.A., *magna cum laude,* from the University of Rochester in 1978. In 1981, he earned his J.D., *magna cum laude,* from the University of Pennsylvania.

Robert E. Heitzman, Jr., is a consulting actuary, specializing in social security systems and in retirement plans sponsored by large multinational companies. His clients have included Eaton Corporation, Coca Cola, the United Nations, and the government of Indonesia. Mr. Heitzman is author of *Employers' Guide to Social Security,* published by Wiley in 1993. Currently he is completing a one-year term as senior pension fellow of the American Academy of Actuaries, where his role is to act as liaison between the actuarial profession and government policymakers. While at the Academy, he authored the *Issue Brief* "Pensions in a Flat Tax World," which analyzes various tax reform proposals and their likely effect on employment-based benefit plans. Previously, Mr. Heitzman was a partner at Kwasha Lipton (1975–1991) and at Ernst & Young (1993–1995), and he is currently a fellow of the Society of Actuaries (1975). Mr. Heitzman received his A.B. from Dartmouth College in 1970.

Curt Mikkelsen, recently retired after 25 years of service with J.P. Morgan as a managing director, was responsible for J.P. Morgan's global benefit plans. This involved the design, financial management, and investment management supervision of the firm's retirement and other capital accumulation programs and welfare benefit plans. Prior to joining J. P. Morgan, Mr. Mikkelsen worked for the Ford Motor Company. Mr. Mikkelsen has been a featured speaker at conferences sponsored by *Institutional Investor* magazine, International Benefits Information Service, and the American Compensation Association. He has co-authored articles appearing in the *Financial Executive* and *Benefits and Compensation International.* Mr. Mikkelsen completed his M.B.A. at University of California, Berkeley.

Albert G. Moore, Jr., is head of the tax and benefits section of the BellSouth Corporation legal department. His duties include advising BellSouth human resources and financial managers on benefit design and administrative issues and in analyzing the impact of potential federal legislation on these matters. He is active in tax and benefits trade associations and professional organizations and is a frequent speaker on taxes and benefits, often offering the "in-house" perspective. He joined BellSouth in 1985 after eight years of private law practice in Atlanta during which he specialized in ERISA and benefits taxation. Mr. Moore holds a B.S. in mathematics from Wake Forest University and M.B.A. and J.D. degrees from Duke University.

James Poterba is a professor of economics at the Massachusetts Institute Technology, where he has taught since 1982. He also directs the Public Economics Research Program at the National Bureau of Economic Research, serves as a director of the American Finance Association, and is a fellow of the Econometric Society. Dr. Poterba's research focuses on the economic analysis of taxation, government expenditure programs, and financial markets. His recent work has emphasized the effect of taxation on employer provision of group health insurance and on the financial behavior of households and firms, particularly with respect to 401(k) retirement saving plans. Dr. Poterba studied economics as an undergraduate at Harvard and received the Doctor of Philosophy degree in economics from Oxford University. He studied at Oxford as a Marshall Scholar and has been an Alfred P. Sloan Foundation fellow, a Batterymarch fellow, and a fellow at the Center for Advanced Study in Behavioral Sciences at Stanford University.

Richard Prosten heads the Washington office of the Amalgamated Bank of New York and the Amalgamated Life Insurance Company of New York, union-sponsored financial institutions connected with UNITE (the Union of Needletrade, Industrial and Textile Employees, AFL-CIO). From 1964 to 1994 he was with the Industrial Union Department of the AFL-CIO, where he served as director of bargaining and research. In that capacity, Mr. Prosten was a frequent union spokesman on benefit issues and a Presidential appointee to the Pension Benefit Guaranty Corporation's (PBGC) Advisory Committee. A past president of the Washington, DC chapter of the Industrial Relations Research Association, as well as the association's National Board, Mr. Prosten is a frequent contributor on labor relations matters. Mr. Prosten's union career began in 1959, when he was elected president of his local union at a Chicago grocery store.

Dallas L. Salisbury has been president of EBRI since its establishment in 1978. Prior to joining EBRI, he served on the staff of the Washington State Legislature, at the U.S. Department of Justice, as assistant executive director for policy at the Pension Benefit Guaranty Corporation (PBGC), and as assistant administrator for policy and research at the Pension and Welfare Benefits Administration, U.S. Department of Labor. Mr. Salisbury has served on the Secretary of Labor's ERISA Advisory Council, and on the presidentially appointed PBGC Advisory Committee, as a consultant to numerous government agencies and private organizations, and as a committee member of many professional organizations. He received a B.A. in finance from the

University of Washington and an M.A. in public administration from the Maxwell Graduate School in Syracuse, NY.

Richard N. Sawaya, Atlantic Richfield Company's (ARCO) director of government and tax affairs, represents the company on tax, trade, health care, pension, and other corporate issues in Washington, DC. Mr. Sawaya is also responsible for federal relations regarding ARCO's activity in the former Soviet Union. He joined ARCO's corporate headquarters in 1979 as a speechwriter. Mr. Sawaya subsequently held several positions in government relations and corporate planning before moving to Washington in 1985. Mr. Sawaya earned his B.A. from Boston College in 1968 and his Ph.D. from Harvard University in 1976. He taught for several years at Loyola Marymount University and administered the University's honors program. He was both a Woodrow Wilson and Danforth fellow.

Stanley C. Wisniewski is a senior professional associate, research, at the National Education Association. He is also the president of Workplace Economics, Inc. (1988–1996). Prior to this, Mr. Wisniewski was an attorney with Connerton, Bernstein and Katz (1982–1988); a research economist with the International Association of Machinists & Aerospace Workers (1980–1982); research director with Service Employees International Union (1975–1979); and assistant professor at American University, Howard University, and the Allentown College of St. Francis de Sales. Mr. Wisniewski received his B.A. from Allentown College of St. Francis de Sales in 1969, his Ph.D. from Catholic University of America in 1975, and his J.D. from the University of Maryland in 1982.

Stephen A. Woodbury is a professor of economics at Michigan State University and a senior economist at the W.E. Upjohn Institute for Employment Research. During 1993–1994, he was deputy director of the Federal Advisory Council on Unemployment Compensation in Washington, DC. His research has concentrated on topics in employee benefits, nonwage labor costs, unemployment, and social insurance. He is the author of several articles on employee benefits and of T*he Tax Treatment of Fringe Benefits* (W.E. Upjohn Institute, 1991). He and William Alpert are currently editing a book of articles by various experts on *Employee Benefits, Labor Costs, and Labor Markets in Canada and the United States,* to be published by the Upjohn Institute. Mr. Woodbury received an A.B. in economics from Middlebury College in 1975 and a Ph.D. in economics from the University of Wisconsin at Madison in 1981.

1. Tax Reform and Employee Benefits
by Dallas L. Salisbury

Introduction

Employee benefits and economic security programs are rapidly being transformed. Some in Congress are now considering tax reforms that would create a new tidal wave of change. Therefore, it is important to assess proposals for comprehensive tax reform and what these proposals would mean for human resources and employee benefits. Major tax reform would come on top of the dramatic change in the employer-employee relationships already being experienced, and tax change that removes relative tax advantages for employment-based programs could serve to accelerate existing trends away from traditional paternalism and toward individual responsibility. Taken together, they have significant potential implications for future economic security.

Characteristics of Proposed Reforms

Tax reform proposals are being categorized as flat taxes, progressive "flat" taxes, value-added taxes (VAT) or national sales taxes, consumption taxes, or "fundamental" reform of the present system through base broadening (elimination of deductions and exclusions). Characteristics of these proposals include:

- All of the proposals are intended to largely eliminate taxation as a factor in individual and corporate decision making by eliminating most existing deductions and exclusions from taxation.
- Most of the proposals seek to encourage employer asset accumulation in retirement plans by allowing deferral of tax on contributions to, and investment earnings within, the traditional "pension" plans—defined benefit and money purchase pension plans. The exception is the progressive "flat" tax proposal that taxes all income as it flows into retirement plans.
- Most of the proposals would not tax interest, dividends, or investment income as it is earned. Some would tax investment income only when it is spent. The progressive "flat" tax proposal is an exception in that it taxes *all* investment earnings as they accumulate.
- The proposals differ in how they treat health and other welfare benefits and participant contributions to defined contribution programs. For example, Rep. Richard Gephardt's (D-MO) proposal would allow no tax-free contributions to any plan—employees would be taxed. The proposal advanced by House Majority Leader Richard Armey (R-TX) and Sen. Richard Shelby (R-GA) allows only after-tax contributions to plans that involve employee contributions such as 401(k), 403(b), and 457 plans, according to language in one section of the bill (the "back-ended individual retirement account (IRA)" approach but with earnings not subject to tax). However, under other sections it would allow pretax contributions to such plans.

Compared with the current tax system, which provides differential tax treatment for employee benefit programs and differential investment sheltering for tax-exempt bonds, life insurance, and annuities, the proposals—except the progressive "flat" tax—would establish a level playing field with all savings eligible for either tax deferral of investment earnings or no taxation of investment earnings.

How the Proposals Will Be Evaluated

How an individual reacts to employment and economic changes now occurring and would react to tax reform depends on the point of reference. Do I analyze as an employer, an employee, or as an individual taxpayer? How old am I? How big a firm do I work for? How "responsible" am I, or, will I take full responsibility for my actions (e.g., poverty in old age if I have never saved)?

For employers, the issues are work force age, the organization's size and profitability, the relative ease or difficulty of attracting and keeping the right people, whether it is difficult to move older workers into retirement, and the extent to which employees might be expected to "demand" benefits that have a tax advantage to them even if not to the employer and/or demand benefits that have no relative tax advantage.

The fundamentals of the tax system in terms of employer and employee decisions have changed little since the 1920s, even as tax rates and rules have changed a great deal. Major tax reform proposals would fundamentally change the system, relationships, and decision making.

The Kemp Commission as a Touchstone

The National Commission on Economic Growth and Tax Reform (the Kemp Commission, appointed in 1995 by former Senate Majority Leader Bob Dole (R-KS) and House Speaker Newt Gingrich (R-GA) and chaired by former congressman Jack Kemp, was charged with setting forth a tax reform proposal that could be embraced by the Republican Party for the 1996 election campaign. The commission's members included advocates of a number of different tax reform approaches.

In January 1996, the commission released a report recommending general principles that it thought any tax reform plan must meet in order to replace the current tax code with a more fair and simple system. The report recommends a single, low tax rate with a generous personal exemption. The chairman noted that the single tax rate should be no more than 20 percent. The report recommended abolishing taxation of capital gains and allowing full deductibility of the payroll tax for workers. The report noted that consideration must be given to deductions such as that for home mortage interest and charitable giving. It also noted the need for strengthening private retirement saving and stated that any tax system "should encourage people to save for their own retirement." While this is not outright support for maintaining tax-favored treatment of retirement savings, the inclusion of such language is important.

The Armey-Shelby Flat Tax Proposal

The flat tax proposal, as introduced by Rep. Armey and Sen. Shelby (H.R. 2060 and S. 1050) in July 1995 would lower all tax rates (to 20 percent immediately and to 17 percent after 12/31/97) and allow employers to deduct the cost of business inputs, cash wages,[1] and retirement contributions to defined benefit and money purchase plans. All employers (including tax-exempt employers in the public and private sectors) would have to pay taxes on the value of noncash compensation other than retirement contributions. For example, an employer providing health insurance would pay tax (income and FICA) on the value of benefits, distributions, and contributions (415 and 4980A), would be repealed. As currently drafted, the bill could *end* pretax contributions (and tax-deductible contributions for employers) to stock bonus, profit-sharing, and other defined contribution plans except for money purchase plans, but would allow tax-exempt and government organizations to establish such plans. The bill contains conflicting language, with one section suggesting unlimited pretax contributions (and tax-deductible contributions for employers) to salary reduction plans, and another repealing the deductibility of contributions to such plans by employers.

Employer reversions of pension assets would once again be allowed—however, only in excess of 125 percent of current liability—once each year (with vesting of participants), and employers would be required to pay regular income tax but not excise taxes. At one and the same time this could serve to encourage employers to maintain defined benefit plans and discourage them from maintaining sufficient fund balances to take care of "rainy day" periods of down investment markets. The proposal would also define self-employed individuals as having an employer, so that they could also have defined benefit and money purchase plans.

The proposal would not tax interest, dividend, or capital gains generated by savings on which taxes have been paid. "Sheltering" and "deferral," as differential tax treatment in terms of qualified plans and life insurance products, would no longer be meaningful or relevant concepts.

The proposal includes other provisions that could have an indirect effect, including a super-majority requirement in order for Congress to pass future tax increases; repeal of estate and gift taxes; zero-based budgeting and decennial sunsetting;[2] spending caps on the growth of entitlements, excluding Social Security, for fiscal years through 2002; maximum spending limits; and a provision for automatic sequestration if revenue falls short of the spending caps.

The Archer View

House Ways and Means Committee Chairman William Archer (R-TX) set forth five "guiding lights" for

[1] All expenditures for employee life, health, disability, and similar benefits woud become nondeductible, and the employer would pay tax on the value of such expenditures.

[2] The bill would serve to sunset programs and require full reenactment, as compared with the present law, where the vote would be to repeal the present law. Currently, the "burden" is on having as much as a two-thirds majority in favor of elimination of an existing program. Under this provision, the burden would shift to a positive vote to maintain the program.

reform. First, to achieve simplicity and freedom from the Internal Revenue Service as it exists today, all loopholes and exceptions in the Internal Revenue Code would be eliminated. Second, the new system would be made savings friendly by ending the taxation of interest earned and investments. Third, the "underground economy" would be curtailed by taxing the purchase of goods and services. Fourth, international competitiveness would be improved by removing the tax from U.S. goods sold overseas and adding it to imported foreign goods. Fifth, to assure fairness, those able to spend more would pay more in taxes; the system would recognize and account for the needs of low income Americans; and, since homes are not consumed items, their purchase would not be taxed.

Archer's principles would allow individuals to set aside an unlimited amount of money in savings and not pay tax on interest and earnings. Taxes would only be paid when funds are spent on consumption. Interest, dividends, or capital gains would be taxed only if used for consumption. For employers, neither cash nor noncash compensation would be given a deduction for tax purposes, allowing the employer to decide on the provision of cash compensation and employee benefits purely against human resources objectives.

The Unlimited Savings Allowance Tax Plan

The proposal of Sens. Pete Domenici (R-NM) and Sam Nunn (D-GA) would combine an 11 percent VAT on business, with graduated consumption tax rates, up to 34 percent, on individuals on the annual aggregate value of consumption expenditures. (Ultimate tax rates would be 9 percent, 19 percent, and 40 percent in 1999). The proposal can be thought of as creating one big savings account for individuals since no income, interest, dividends, or capital gains would be taxed until spent for consumption.

This proposal would allow limited individual deductions for charity, mortgage interest, and education. It would allow unlimited savings without immediate taxation or immediate taxation of earnings on assets, with taxation occurring only when savings and earnings are spent. The savings portion of the proposal has been described as "quite complicated" as it would require careful tracking of dollars by the individual and an annual detailed tax return. Employment-based plans and IRAs would be allowed, but they would have no relative tax advantage over any other savings since no income or earnings on assets would be taxed until spent. As currently proposed, the Nunn-Domenici plan does not change qualified plan rules per se, but contributions to plans would not be deductible from the 11 percent VAT. As savings, they would not be taxed to the individual until taken as distributions and then only when spent. In the current tax system context, this would appear to be a form of double taxation of employer contributions to plans.

The Nunn-Domenici proposal would also change the tax treatment of all other employee benefit expenditures that provide in-kind benefits by making them subject to the 11 percent VAT and treating them as taxable income to the individual.

The Nunn-Domenici proposal would also change the tax treatment of FICA taxes by providing a tax credit against income taxes and then making an explicit allocation to the programs in order to pay benefits. This would appear to eliminate some of the insulation from the annual budget process that the programs now experience, as benefits are now paid from the trust funds and are off budget. Under this proposal, Social Security benefit and spending levels would experience added pressure each year as budget appropriations are decided.

While the Nunn-Domenici proposal does not provide simplicity, it is savings friendly; it would attack the "underground economy"; and it would attempt to deal with international competitiveness.

The Gephardt Progressive "Flat" Tax

Rep. Gephardt's proposal contrasts with others by providing an income tax with full taxation of interest, dividends, and capital gains; with progressive rates; and with the elimination of virtually all deductions except the mortgage interest and standard deductions.[3] His proposal as currently stated would eliminate the favorable tax treatment of all employee benefit programs by providing for immediate taxation of either the employer or the individual. The progressive "flat" tax Gephardt proposal differs from the other proposals by not favoring savings over consumption as much as the present system, whereas the other proposals favor savings more than the present system.

[3] Seventy-five percent of taxpayers would pay a 10 percent rate, with rates of 20 percent, 26 percent, 32 percent, and 43 percent above that. The standard deduction would be $5,000 for a single taxpayer, $7,350 for head of household, and $8,350 for married couples. The personal exemption would be $2,750.

Gephardt's proposal would encourage employers to pay employees cash only, leaving all retirement saving, health, life, disability, and other economic security decisions to the individual. The employer would have an incentive to provide benefits through a flexible choice program, if at all, to avoid tax complications, similar to the incentives provided by the Nunn-Domenici proposal.

Gephardt's proposal contains significant simplification provisions. Thus, he sets the stage for debate with a message that all tax reform proponents favor simplification but highlights the different positions concerning who pays the taxes, at what rates, and when.

Issues for Consideration

This mix of proposals offers significant contrasts in the tax treatment of qualified retirement plans and other employee benefits. Most of these tax reform proposals essentially take most or all of the retirement savings tax incentives away from the employer and give them directly to the individual. These proposals focus on individual opportunity and responsibility, consistent with the growth of defined contribution programs over the past 15 years. Policymakers face a number of design questions.

- Should all qualified plans be treated the same, as under current law, or should defined benefit and money purchase plans be given unique treatment as "retirement" plans versus "savings" plans, as provided for in the Armey-Shelby proposal? How would this affect behavior?
- Employers might choose to maintain funded defined benefit plans on a strategic basis for work force management, or consider the adoption of money purchase defined contribution plans for that purpose. Employers would be likely to continue to focus on the value of prefunded programs, competitive advantage, and disciplined saving through these plans. Where employers have already moved away from defined benefit plans and toward individual responsibility, we would likely see acceleration of this movement. Where contributions are from after-tax dollars, a new form of savings plans that would not have to be qualified, using payroll deduction, might be offered in partnership with financial institutions. Prior to 1978 and the advent of 401(k) plans, it was common for employers to maintain savings plans, but they then had the advantage of more favorable treatment of investment earnings than was accorded regular savings. This difference would not exist under most tax reform proposals.
- Employees might ask employers the simple question, "Will I receive in added wages the money that would have been contributed to a pension plan if there is no plan to which you contribute? If yes, give me the money, a means of payroll deduction, and a route to unlimited investment choice."
- Employers would be likely to find it more expensive to pay employees than to contribute to retirement savings plans, particularly considering the difficulty involved in attributing exact dollar amounts to each employee in traditional defined benefit plans. This attribution would be even more difficult for those plans with deferred vesting and integration with Social Security.
- Are employer contributions treated as taxable income to me so that I must pay tax? If yes, will I have the cash to pay the taxes on the money contributed to the plan? If not, I might again prefer the income to the plan contribution. This choice would be most pronounced under the Gephardt proposal.
- Should all plans and savings be treated as nondeductible for the employer but sheltered for the individual as provided for in the Nunn-Domenici proposal? Should savings be the goal, versus retirement savings? How would this affect behavior?

For the individual, the ability to save after-tax dollars eliminates the emotional driver of immediate tax savings. Given the option, would employees prefer the immediate tax savings and the deferral of tax on investments as provided for in Armey-Shelby as an option, thus causing them to urge employers to maintain defined benefit and money purchase plans?

IRAs provide a basis for assessment of how individuals would react. Nondeductible IRAs are being used by fewer than 5 percent of the eligible taxpayers. Fully deductible IRAs were used by 16 percent in the last year of full deductibility, while among employees with incomes above $50,000 per year nearly 60 percent contributed. Given the presence of employment-based plans, one might not expect better. The question: without employment-based plans available, how much would people save? And, how much less might be saved for retirement or might still be available at retirement due to the shift of focus to general savings?

How Might the System React?

- Employees would likely find defined benefit and money purchase plans attractive if they *did not* feel employers would give them *the full value of contributions as added cash* if the plans were not offered. Full cash payment would be unlikely. With other defined contribution plans, where employer deductions would be lost under several proposals, employers would likely choose to pay some added cash, simply eliminate the plans, or offer the plan with payroll deduction only in order to provide the employee a group administrative cost advantage. They might also offer expanded financial planning opportunities.

- Should health and welfare benefits contributions be nondeductible/taxed for the employer and nontaxable for the employee as proposed by Armey-Shelby, or nondeductible for the employer and taxable for the employee as proposed by Gephardt and Nunn-Domenici? Since there is a tax, would there be no difference? Or, would taxes affect behavior in different ways? Taxes paid by the employer would be on aggregate health expenditures and would not affect the individual; thus employee behavior would be unlikely to change in terms of health care consumption. However, were employees to be taxed, they might seek or demand less health insurance in order to reduce their taxes.
- Either approach would likely lead to the expansion of health care choice and flexibility for individuals, a trend that began in 1978 but is not yet the general rule. The argument made by former Rep. Jim Cooper (D-TN) in his 1993 comprehensive health reform proposal in favor of the equivalent of the Armey-Shelby employer tax treatment would apply: taxation of health costs would make employers more careful purchasers. Facing taxes on contributions, they would find it more advantageous to funnel deductible cash compensation into a flexible benefits plan that offers health insurance options and in which many employees would choose lower cost health insurance than they now have.

The behavioral questions are beginning to be discussed by analysts, employers, and employees. However, the assessments are filled with contradictions. Some argue that, in the absence of relative tax advantages, employers and individuals would not want employment-based plans. Others believe that many employers would still want to maintain some plans for competitive advantage and to assure a savings pool to facilitate work force exit, and that employees will want the ease and discipline of payroll deduction savings.

Consequences for the Nation

Demographics are quickly bringing us an older work force and a growing retiree population. Many employers, reporters, and policymakers are beginning to focus more on questions of retirement savings adequacy and people's ability to retire in the decades ahead. Many employers are just beginning to win the savings education battle with employees. Public- and private-sector organizations are just starting to engage in a national savings education effort. How would these savings concerns interact with changes in the tax law? Would change disrupt the system so dramatically that savings would drop during the adjustment period? Retirement savings programs such as defined benefit plans, money purchase plans, or matched 401(k)s would become much more clearly "coercive" as a forced allocation of compensation in the absence of today's relative tax advantage. Having just begun to explain the virtues of tax deferral to employees, would we slide backward? How much would a required change in message serve to confuse individuals?

Some proposals allow employer deductibility for some plan types and not for others, further complicating decision making. What would this mean for employee relations? Would employers be sufficiently motivated by the need to manage exit from the work force to maintain plans when contributions are not deductible and when there is no special treatment for investment earnings in plans relative to other savings?

What would be the consequences for the nation if individuals cannot afford to retire? We know from the Social Security trustees' report of April 1995, that future retirees will get less from Social Security and Medicare, and at later ages. This reduction will serve to increase the resources they need from personal savings to retire before they begin drawing Social Security, and after, to maintain a desired lifestyle. What if employer plans disappear just as the public programs decline? Will individuals at all income levels save the same amount as would have been provided through employment plans, and more?

We know that individuals have not universally taken advantage of employment-based defined contribution plans even when generous matching contributions were offered. Would these nonparticipating workers be more likely to save with a consumption tax? Available research on qualified plans and IRAs suggests that the answer is no, leading to the prospect of lower rather than higher savings. On the other hand, research by economists such as Nobel prize winner Franco Modligliani suggests that access to funds without access restrictions based on age or the imposition of special taxes would probably encourage many individuals to save more. Would the end result be more or less total savings? What would be the effect on retirement income? What would be the implications for the ability to get individuals to retire? What would be the employment and political fallout if even fewer individuals reached the "golden" years with savings than is the case today? What if there were more savings in the aggregate after tax reform, but they were concentrated among fewer people? Would that produce a groundswell for a new round of reforms?

Finally, what would be the ultimate impact of these proposals on public demand for expansion of Social Security and Medicare? Some suggest that these programs will essentially be privatized in the years ahead, making these concerns moot. Would they remain moot if elderly poverty rates began to grow over time as a result of lower retirement savings due to fewer employment-based retirement plans?

The Future of Employee Benefits in a Tax Reformed World

Each of the tax reform proposals, if enacted, would raise fundamental questions about the future of employment-based plans and other employee benefits that partially rely on tax advantages to draw participation. Given no relative tax advantage for contributions to a defined contribution plan, or for investment earnings within the plan, fewer individuals would be likely to contribute to an employment-based plan. Fewer individuals would purchase group universal life rather than multiyear fixed-rate term insurance. Employers see it as advantageous to provide a match in a plan when the match is tax deductible but may not see an advantage if that match is not deductible. If given the choice between a qualified plan and cash in a flexible benefits plan, with the accompanying ability to make their own decisions, many workers would prefer the latter.

Health and welfare benefits have been moving toward a system of options and flexibility. This movement could be expected to become nearly universal, and many employers could choose simply to pay cash, open the door to health firms to market to employees, and provide payroll deduction premium payment.

Some major employers are contemplating such changes without tax reform, and tax reform would certainly increase their numbers. Outsourcing has been a movement of the early 1990s as employers seek to focus on the real "businesses" they are in for a profit, letting specialists profit from work that supports the firm. In addition, the use of part-time and contract workers has expanded as employers seek to operate with lean work forces that can expand or contract with customer or production demands. Both trends could be expected to accelerate, with implications for employee benefits, in a post-tax reform work place as individuals see even less reason to remain with one firm for long periods.

The ability of employers (including the self-employed) to maintain defined benefit and money purchase plans with the unrestricted design and contribution flexibility allowed by the Armey-Shelby proposal would allow an end of any unfunded nonqualified deferred compensation. Individuals might well prefer payment in current cash instead of deferred compensation under a new tax system, while employers might seek to maintain plans to provide an incentive for employees to remain and to retain some ability to manage work force exit.

Small employers, having always been motivated largely by the tax advantages, would be less likely than ever to maintain defined benefit or money purchase plans, even with the elimination of much regulation. However, the end of heavy regulatory requirements, including recordkeeping and testing, might lead more small employers to allow financial institutions to offer payroll deduction defined contribution programs to their employees.

Conclusion

Many organizations are thinking about the macroeconomic implications of tax reform. Many individuals are thinking about the impact on their own tax bill. Fewer are thinking about the business, profitability, human resources, employee benefit, and retirement income security implications, but that analysis is beginning. These implications will be far-reaching. The combination of unintended consequences and intended consequences that do not materialize could leave us short of meeting the proposals' objectives. Or, we could exceed them.

Bibliography

American Institute of Certified Public Accountants. *Flat Taxes and Consumption Taxes: A Guide to the Debate.* Washington, DC: American Institute of Certified Public Accountants, 1995.

Conte, Chris. "Comprehensive Tax Reform: Implications for Economic Security and Employee Benefits." *EBRI Notes,* no. 6 (Employee Benefit Research Institute, June 1996) 1-5.

Employee Benefit Research Institute. Comprehensive Tax Reform: Implications for Economic Security and Employee Benefits. EBRI-ERF Policy Forum held April 30, 1996, Washington, DC. Tapes available. Washing-

ton, DC: Employee Benefit Research Institute, 1996.
_______. *Comprehensive Tax Reform: Implications for Economic Security and Employee Benefits.* Washington, DC: Employee Benefit Research Institute, forthcoming.
_______. *Pension Funding & Taxation: Implications for Tomorrow.* Washington, DC: Employee Benefit Research Institute, 1994.
Hall, Robert E., and Alvin Rabushka. *The Flat Tax.* Second edtion. Stanford, CA: Hoover Institution Press, 1995.
Heitzman, Robert E. *Pensions in a Flat World.* Washington, DC: American Academy of Actuaries, October 1995.
McTeer, Bob. "Tax Reform: An Opportunity To Increase Our Saving." *Economic Insights*. Vol. 1, no. 2. Dallas TX: Federal Reserve Bank of Dallas, n.d.
Pechman, Joseph A. *Federal Policy*. Fifth Edition. Washington, DC: The Brookings Institution, 1987.
Salisbury, Dallas L. "Employee Benefits in a Flat Tax or Consumption Tax World." *EBRI Notes,* no. 9 (Employee Benefit Research Institute, September 1995): 1-11.
U.S. Congress. Joint Committee on Taxation. *Selected Materials Relating to Federal Tax System under Present Law and Various Alternative Tax Systems, Prepared in Connection with House Ways and Means Committee Retreat Held March 1-3, 1996, Issued March 14, 1996.* Washington, DC: Bureau of National Affairs, Inc., 1996.
Tax Analysts. *Tax Notes.* Special Reports and Policy sections (January 22, 1996).
Woodbury, Stephen A., and Wei-Jang Huang. *The Tax Treatment of Fringe Benefits.* Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1991.

2. A Labor Perspective

by David Blitzstein

Introduction

Comprehensive tax reform in the form of the various proposals described and analyzed in the papers presented in this volume would in my opinion weaken the foundations and ultimately destroy the employment-based pension and health plan systems. There are two ways to interpret these proposals in terms of the politics of the day:

- The first interpretation uses as a starting point that, like most policy-related to employee benefits over the past 20 years, these tax reform proposals are solely revenue driven and ignore the devastating impact on retirement and health policy.
- The second interpretation is more ideological. It suggests that the authors of these tax reform proposals no longer support employment-based benefit plans, and they are seeking a total replacement of the employment-based system with a system that shifts retirement and health care responsibilities back to individuals.

Whichever interpretation compels you, the bottom line is that tax reform in its current guise represents a troubling way to conduct public policy. From labor's standpoint, national retirement policy and health care policy require equal billing with tax policy. All countries with well-developed pension systems have historically provided preferential tax treatment for saving through pensions. Congress cannot afford to revamp the nation's tax system without carefully considering the effect on employee benefit institutions that it has fostered for 75 years through tax preferences. Tens of millions of workers who have embraced and planned their working lives around the current system of employment-based benefits will demand a clear explanation as to why the system is no longer worth the support of the federal government.

At the same time, I do not sense a groundswell among working Americans to replace employment-based plans with cash substitutes so that individuals can purchase their own benefits. This is confirmed by surveys conducted by the Employee Benefit Research Institute/The Gallup Organization, Inc. Regardless of the fact that corporate America is abandoning its social contract with its employees and eliminating benefit obligations, employees desire more benefit coverage from their employers, not less. American workers may be economically weak vis a vis their employers at the current time, but they have not accepted the notion that they are all leased transient employees with no attachment to their employer. Moreover, we in the labor movement have serious doubts that companies would replace in-kind pension or health insurance contributions with cash-equivalent wage increases, as assumed by many of the economic models and theories discussed in this volume.

The Impact of Comprehensive Tax Reform on Employment-Based Plans

The contributors to this volume suggest degrees of adverse impact on employment-based plans as a result of tax reform. They differ only in magnitude of impact on the employment-based system and actual cause and effect. I differ with some of the authors in that I take an extreme view—if tax deductibility is removed from employer contributions or if benefits are added to employees' tax base, I believe the employment-based system of benefits will collapse. Many of the authors argue that employers provide benefits for reasons other than tax subsidy. I agree. But if the economic cost advantage of employee benefits disappears, I'm convinced that employers will take immediate steps to get out of the benefit business. Richard Sawaya[1] and I are in total agreement on that.

My collective bargaining and trustee experience is also instructive on this matter. I have never met an employer who was willing to contribute non tax-deductible contributions to a benefit plan. The current funding rules for pension plans have distorted employer thinking about contributing to existing plans. Many employers set funding policies by contributing to plans at the minimum required by law. Competitive pressures have encouraged many employers to protect plan surpluses by refusing to improve benefits so that they can maintain a perpetual contribution holiday. The fact is companies are interested in making the least contribution to their pension plans. Take away the tax subsidy, and there will be a mass termination of defined benefit plans.

---

[1] See Richard N. Sawaya, "A Possible Employer View," in this volume.

My views are supported by the actions of employers in the past. The fact is employers have refused to contribute to plans when tax-deductible limits are met, even when the collective bargaining agreement calls for a continuing contribution requirement. Both the United Mine Workers and the National Football Players have litigated such cases. During the health care reform debate, employers began proposing contribution limitation language in collective bargaining in response to health insurance tax cap initiatives in various legislative proposals. These experiences suggest that employers would resist pressures to contribute non tax-deductible dollars to any plan.

On the health plan side, I am troubled by the economic assumptions put forth by Cutler[2] and Poterba[3] that the tax subsidy for health insurance leads to overinsurance, which has then resulted in a spiral of medical inflation. The theory of overinsurance becomes the rationale for eliminating all or part of the tax preferences for health insurance. First, I would argue that the U.S. population has too little health insurance, not too much. A study in the October 25, 1995 *Journal of the American Medical Association* estimated that 29 million Americans, or 18.5 percent of the privately insured population, were underinsured in 1994. Adding the uninsured to the underinsured, a total of one-third of the U.S. population younger than age 65 is inadequately insured in any given year.

Gruber and Poterba rightly point out that employee contributions now account for 20 percent of total employer health care premiums, and that three-quarters of these employee premiums are paid after tax. Although lost in the measurement of the after-tax price of health insurance, employee's direct financial obligations for health insurance premiums have increased 200 percent between 1983 and 1993 according to the Bureau of Labor Statistics. In 1993, the average employee was paying $32 per month for single coverage and $107 per month for family coverage. Workers are already incurring a unofficial tax for health coverage. With real incomes stagnating and employees carrying a larger health premium burden, if tax preferences were withdrawn, the cost shift to employees would be unbearable.

What Can Be Done

There is some irony in the fact, that while the rest of the world is working to create or expand employment-based pension systems, we are entertaining tax reform proposals that would limit or destroy the very system that has become a model for the other industrial and emerging nations. Gale and Engen[4] reminded us of the crucial role played by pensions in terms of share of personal savings. Our employment-based system has successfully generated national savings and provided workers with added retirement income. The question is, are we willing to bet the survival of these successful pension institutions on questionable economic tax theory? I hope not.

Conclusion

Our focus should be on expanding pension coverage and addressing the subject of retirement income adequacy. Pension coverage in the United States—at 50 percent—is too low, and I am sure that substandard pension benefits are as much a problem as the underinsured in health care. Therefore, I appreciate the comments of Forman[5] and Hardock,[6] who both see opportunities in the tax reform debate for expanding retirement security. Forman's example of a consumption tax reform combined with a mandatory universal pension does strike a certain fascination in terms of developing a new social contract among labor, management, and government. In addition, the suggestion of Forman and Halperin and Graetz that tax, pension, and Social Security reform should all be considered comprehensively in the context of national retirement policy makes tremendous sense.

Finally, the notion that individuals must become totally responsible for their retirement and health care security, assuming all levels of societal risk, presents a fundamental divide within America. In a nation of 270 million people, this becomes a prescription for economic polarization with real winners and real losers. A clear consensus has emerged from the discussions in this volume that lower and middle income workers would be hurt by a tax reform system that rejected the role of employment-based plans. Borrowing from Hardock, if tax reform cannot guarantee incentives to save, lock money into retirement savings, generate patient capital, promote savings, and afford administrative savings, it is not good public policy.

---

[2] See David M. Cutler, "Comprehensive Tax Reform and Employment-Based Health Insurance," in this volume.

[3] See Jonathan Gruber and James Poterba, "The Impact of Fundamental Tax Reform on Employment-Based Health Insurance," in this volume.

[4] See Eric M. Engen and William G. Gale, "Comprehensive Tax Reform and the Private Pension System," in this volume.

[5] See Jonathan B. Forman, "The Impact of Shifting to a Personal Consumption Tax on Pension Plans and Their Beneficiaries," in this volume.

[6] See Randolf H. Hardock, "The Reality of Tax Reform: What Tax Reform Means for Employment-Based Retirement Plans," in this volume.

3. One Personal Labor View

by Stan Wisniewski

Introduction

Just as there is no such thing as a monolithic employer view on the detailed implications of the various proposals currently being advanced to change the federal tax structure, so also there is no such thing as a single labor view. This is because, even within the unionized employment sector, there are substantial differences in the combination of benefits employees enjoy and the characteristics of the pension systems and health insurance plans that may cover these employees.

As a simple example, consider the pension benefit systems covering private-sector employees compared with those covering public-sector employees. If you work for a medium to large private-sector employer (with more than 100 or more than 200 employers, respectively), according to the latest Bureau of Labor Statistics data, you are probably one of the 45 percent of all employees who are covered by a defined benefit plan and a supplemental defined contribution plan in addition to Social Security. By contrast, only 3 percent of public-sector employees are covered by both a defined benefit plan and a defined contribution plan, and 24 percent of public employees are not covered by Social Security. Moreover, the private-sector employee whom I have described typically makes no contribution toward his or her defined benefit plan, while 72 percent of public employees share this cost—typically contributing 5.9 percent of their earnings to their defined benefit plans.

Clearly, changing the tax treatment of pensions will not have the same degree of impact on all employees and, in some instances, perhaps not even produce the same direction of overall impact when all possible considerations have been factored into the equation. I raise this warning to indicate that my observations may not adequately anticipate the ultimate response of any portion of organized labor to any actual proposal. Instead, they represent one person's initial ruminations on the general subject.

Health Insurance Benefits

To the extent that health insurance premiums are treated the same as any other expenditure, the cost of the premium will rise and coverage—with access levels already far less than universal—will diminish further. I don't disagree with the conventional view that workers who are most likely to drop health insurance are those who are healthy. I also see some marginally healthy individuals dropping coverage where they feel that the personal administrative and transaction costs of having individual coverage are too burdensome. As these relatively healthy workers leave the risk pools, premiums will rise because the average probability of any one person in the risk pool incurring medical expenses will rise. Therefore, the bottom line is that even fewer people will have access to health insurance coverage than have it today, unless employers step in to subsidize the increased cost because they see some value in promoting a healthy work force.

I am not sanguine about employers voluntarily stepping in to subsidize the cost of health insurance in terms of seeing a value to having a healthy work force—employers have been steadily distancing themselves from such subsidies in recent years. By rough analogy, having an educated work force is of clear value to employers, yet while reaping the benefits of such improved abilities, employers, as a collective group, appear to be willing to pay only a small portion of the price of education. Instead, they seem content to benefit from this external economy provided by the society at large.

Similarly, by analogy, in some cases where adverse health conditions are the product of occupational injury and illness, some employers even seem willing to externalize the diseconomies they have created by refusing to fully bear the costs of their activities. So stepping in to subsidize higher health care costs seems unlikely in an environment where many employers take the position that "It's not my problem."

As Richard Sawaya states,[1] "Given global trends in technology and consumption, Fortune 500 companies will restrict their work forces to skilled elites that devise and implement business plans—and all other functions can be outsourced or handled on a part-time basis." Under his scenario, it is hard to see these temporary de facto employers willingly paying for the higher health care costs incurred by their contingent work force. They have, in effect, taken one further step away from any responsibility. By the way, this is not only a question of globalization creating less

[1] See Richard N. Sawaya, "A Possible Employer View," in this volume.

company loyalty toward employees but a broader question of corporate citizens showing less loyalty and responsibility toward the society that created them.

The bottom line is higher health insurance premiums in the short run and pressures building over the long run to address real or perceived inequities. However, I do not see a wholesale abandonment of the present system of employment-based insurance even if these major federal tax changes are implemented, because I think that the current combined employer/employee Social Security payroll tax still provides some motivation for maintaining this benefit rather than a larger cash equivalent. Also, while the future favorable treatment of such benefits in terms of state income tax may be in doubt since many state systems piggyback on the current federal system, it is not clear whether some state tax benefit may also remain in play. Therefore, while the direction of the impact is clear, the magnitude depends on a large number of implementation details and other considerations.

Pension Benefits

Most of the proposals (e.g., those advanced by Sens. Richard Shelby (R-AL), Sam Nunn (D-GA), Pete Domenici (R-NM), and Richard Lugar (R-IN) and Reps. Dick Armey (R-TX), and Bill Archer (R-TX) are either implicitly or explicitly a consumption tax, inasmuch as they tax wages or profits but not earnings from savings or investment activities. Therefore, the issue before us as far as pensions are concerned is what would be the effect of a change in the law that would eliminate all current tax-favored savings and investment activities?

I agree that the impact of these proposals would be to make the current plans less attractive to plan sponsors and less advantageous to some individual plan participants—with the result that the number of tax-qualified plans and their rate of asset growth might diminish.

How much of an impact is the question. In other words, if employees no longer need to participate in a tax-qualified plan to shelter savings for retirement, what would induce them to continue to use the current defined benefit and defined contribution retirement savings vehicles and to put the same amount of money into them? Some inducement may stem from the individual's lack of information concerning future target income needs at retirement or how to achieve these target income needs most efficiently. Admittedly, very few of us do a very good job of retirement planning and investing for retirement on our own—we're simply too busy doing our regular jobs and taking care of our families to think these things through very well.

But at the same time, not all of us recognize our shortcomings in this regard. No doubt, if told that the tax consequences would be the same, a significant number of potential plan participants would opt to take their money and invest it themselves. That is the problem—many of these individuals would simply not do the most efficacious job possible in terms of either asset allocation or choice of investments within asset classes, etc., to meet their target retirement income needs. Moreover, their target retirement income needs likely will have increased because they will be paying more in consumption taxes — i.e., older people tend to consume a greater proportion of their income than other age groups. So these people will need to rely more heavily on their Social Security payments precisely at a time when the demographics are already putting a strain on the Social Security system. (Also, at a time when some of the suggested fixes for the Social Security system, such as raising the normal full retirement benefit age, fly squarely in the face of this society's employment biases against senior citizens.) In other words, further erosion in employer pension plans will only exacerbate the retirement income gap.

Still other possible consequences of adopting a consumption tax system include encouraging other forms of "saving" at the expense of retirement saving (e.g., saving for my daughter's college education, since there is no tax advantage for one purpose as opposed to another) and encouraging participants to tap their savings prior to retirement (e.g., the enticement of the lump-sum distributions that employers might offer in order to eliminate existing pension plan obligations during the transition). Either of these reductions in savings that were previously targeted to support retirement living would produce retirees with inadequate resources to meet their retirement needs.

In short, shifting to a consumption tax would set in motion a series of developments that would hasten the need to talk about societal strategies such as fully portable, mandated employer-paid pensions to supplement Social Security benefits and assure an adequate retirement income level for workers.

Finally, the most interesting thing to me about consumption tax advocacy is that, ostensibly, at least one of the major purposes is to encourage greater savings. However, Engen and Gale[2] report that switching to a consumption-based tax system, by reducing pension coverage, might

---

[2] See Eric M. Engen and William G. Gale, "Comprehensive Tax Reform and the Private Pension System," in this volume.

not increase overall savings because retirement savings currently represent the bulk of personal savings.

Conclusion

Studies of all the possible impacts of a consumption tax for different segments of the economy yield little if any empirical evidence to support the "simple" consumption tax assumption that such a tax would definitely stimulate the savings rate (and by implication, automatically stimulate productive investment spending). Indeed, there is very little discussion among advocates of this measure concerning how they would pick a particular rate or set of consumption tax rates to reach a specific level of savings they regard as adequate. In fact, when advocates discuss consumption taxes, the emphasis always seems to be on keeping the rate as low as possible without much examination of the ultimate impact on savings. Even the recent Kemp Commission, when endorsing the notion of a flat tax, did not encourage the selection of a tax rate based on promoting a particular rate of savings but rather said that they "encourage the adoption of as low a rate as possible within the framework of budget equilibrium."

It is precisely this inattention to detail and vague agenda that at once cause me to view the proposals as both lacking seriousness and yet threatening the most serious consequences for the economy.

4. A Possible Employer View

by Richard N. Sawaya

Introduction

If the relative tax advantage accorded employment-based benefits were to disappear, I believe large employers would get out of the business of benefits. When the infamous sec. 415 nondiscrimination rules took effect, executive compensation came to be almost exclusively a matter of cash and deferred cash, all "unqualified." Consequently, large U.S. employers came to regard defined benefit pension plans as little more than a nuisance. At the same time, the general increase in health care costs has made employment-based health care a nagging cost pressure for most large employers.

In both cases, if the relative tax advantage enjoyed by the recipients of these pension and health benefits were to disappear (as many argue they should to increase horizontal equity among taxpayers), there would be no reason for large employers to maintain such compensation arrangements. If possible, they would make lump-sum distributions of the present value of accrued pension obligations, perhaps augment future defined contributions to employee savings, and further gross up salaries equal to the cash costs of other benefits.

I will not presume to speculate on what position the AFL-CIO would take on such a course. I do think that the question of economic security and employee benefits—defined to include public entitlements of Medicare and Social Security as well—ought to be a strategic issue for large companies. However, I want to approach it from a context other than the tax code per se.

The New Employment Marketplace

Dallas Salisbury touches in part what I have in mind when he alludes to corporate downsizing, outsourcing, small groups of core employees, and the growth of the contingent work force.[1] One needs to add the replacement of employee functions by information technology to the litany.

Recently, Fortune magazine released its annual ranking of the Fortune 500 companies. Profits were up 13 percent—the fourth straight year of double digit growth. Net full-time employment growth was zero on the 500's base of 20 million.

Meanwhile, 60 Minutes featured Leslie Stahl asking Robert Allen why he's worth $20 million in compensation in the year he has eliminated 40,000 positions at AT&T—correcting the strategic mistake he made years ago with the acquisition of NCR in his unsuccessful quest to make AT&T a computer powerhouse.

The fact is the traditional contract between large employers and their employees no longer exists. Moreover, there is a double disconnect in the structure of corporate compensation: one between the rules for top management versus the rules for rank and file and another between the new employment marketplace and traditional compensation and benefits.

I want to suggest that what works at the top should work everywhere in the organization. Moreover, what works for people at the top in fact makes sense for everyone in the new employment marketplace. Put another way, I think the benefits/security question should be approached as an issue of corporate governance.

Corporate apologists usually cite the sanctity of shareholder value as the corporation's sole raison d'être. But they always stress its eventual societal utility. In their view, the new employment marketplace is a rational response to competitive conditions—the process of "creative destruction" the economist Joseph Schumpeter identified as the hallmark of capitalism. Eventually, greater economic well-being will result from the present dislocation and the attendant insecurities and losses suffered by individuals. Any attempt to modify the process—particularly any government attempt—can only hurt not help. This is, in fact, a pragmatic argument—a variation of the utilitarian's greatest good to the greatest number.

Critics of this argument are also pragmatists. The economy is a human creation, justified by the good it produces for society. Society is well served by stable employment at "living" wages under "reasonable" working conditions. Sometimes, government intervention is justified to achieve societal well-being.

In this view, a corporation must not only maximize profit for shareholders but also adjudicate the claims of other stakeholders: customers, employees and their fami

[1] See Dallas L. Salisbury, "Tax Reform and Employee Benefits," in this volume.

lies, and local communities. Some stakeholder claims on corporations are enforced by law, e.g., the history of environmental regulation. Others are encouraged by law, e.g., tax advantaged employee benefits.

The fact is the Fortune 500 have operated more or less from the stakeholder view, in spite of free market rhetoric. The point is to do good by doing what works.

Large employers know the old employee contract—do your job and you keep your job and accrue your benefits—doesn't work. Given global trends in technology and consumption, Fortune 500 companies will restrict their work forces to skilled elites that devise and implement business plans. That is what will be "firm specific." All other functions can be outsourced or handled on a part-time basis.

In terms of compensation, these skilled elites may be more usefully thought of as very large partnerships, a compression of core employees around a managing partner, the CEO. Why not a corresponding compression of compensation, both in terms of scale and structure? Put another way, why not consistency of performance expectation, evaluation, and reward throughout the organization?

Replacement of rank and file salary and pension compensation with the structure of executive compensation—base salary plus profit-based bonuses and stock options—would substantially increase portability and more equitably apportion the risks and rewards among all employees of large companies.

The tax rule is simple: income is income, to be taxed once and once only—either when earned or when consumed. My economist friends tell me this is an economic equivalence. But if the rule has real meaning for less and less of the U.S. work force, perhaps that suggests that to frame the issue of retirement security in terms of the tax code is to misframe it.

More equitable apportionment of risks and rewards within large company work forces is only part of an adaptation suggested by the new employee marketplace. But I believe it would be highly effective within companies and yield benefits to the corporate sector beyond plant gates and office towers.

Conclusion

Americans know that new rules are being set for the nature and conditions of work. They plainly don't like them. That is the significance of Pat Buchanan's socially conservative corporate bashing. Legislators, regardless of political affiliations, respond to voters. Corporations don't vote.

I think a corporate-led reformation of employee compensation, pursued deliberately to benefit employee stakeholders, would go a long way to relegitimize the corporation in society. It might also provide a starting point for national consideration of how to reconstruct Social Security and Medicare before these public retirement programs become bankrupt.

5. A Public Policy Analyst's Perspective
by Gerald Cole

Introduction

The goals of tax reform are laudable: eliminate economic distortions caused by the tax system and increase economic growth. To accomplish these objectives, the major tax reform proposals eliminate the tax on investment income and capital gains. They also broaden the tax base by removing numerous deductions for individuals and businesses.

The Implications of Tax Reform

As far as employment-based pension and retirement plans are concerned, the principal effect of the various tax reform proposals is to vitiate the relative tax advantage now enjoyed by these plans as compared with ordinary savings. To what extent will this reduce coverage by employment-based pension plans? Who will be affected by any reduction? What will happen to the already low national savings rate? The discussions in this book attempt to answer these questions.

Although, as expected, no one is able to provide definitive answers regarding the magnitude of the effects, all agree that some shrinkage in coverage and employer contributions would occur under any of the tax reform proposals. Stephen A. Woodbury estimates that making pension contributions taxable would reduce pension coverage only from 57 percent to 51.5 percent of workers but would reduce employer contributions to pension plans by 40 percent to 50 percent.[1] Engen and Gale conclude that the reduction in pension contributions could largely, or even completely, offset the gain in other savings from tax reform.[2] If any gains in savings from tax reform are offset by losses in pension savings, where is the engine for more rapid economic growth?

However, I am afraid that these analyses tend to understate the devastating effects of tax reform on employment-based plans. Woodbury's economic analysis uses a factor to estimate the effect of reductions in tax rates on pension plans that was developed using very small changes in the marginal tax rates. It is likely that this factor will be much greater when, instead of a marginal change in tax rates for savings, there is a complete elimination of taxes on investment income and capital gains. This conclusion is fully consistent with the views of Alvin Rabushka, author of *The Flat Tax*[3] and one of the acknowledged fathers of the flat tax proposal being advanced by Rep. Dick Armey (R-TX). When interviewed by a reporter for the *New York Times*, Rabushka agreed that many pension plans would cease to exist.[4] He also agreed that many workers would not save for retirement, even if the employer increased their pay by the amount it was contributing to the pension plan.[5]

The effect on workers' retirement security is far from trivial. Almost 70 percent of nonagricultural married workers are covered by an employment-based retirement program.[6] Loss of these programs could jeopardize the retirement security of covered workers and lead to increased demands for Social Security when the baby boomers begin to retire. These increased demands will come at a time when the Social Security system is already severely underfunded and the debate on whether to shore up Social Security by benefit cuts or tax increases is under way. Some economists believe that baby boomers are not now saving enough to provide for their retirement needs. Against this backdrop, does it make sense to drastically rework the current tax system, when the gains are uncertain and there is little doubt that any of the contemplated reforms will reduce coverage under private retirement plans?

To ameliorate the adverse effects of tax reform on employment-based retirement plans, the Armey flat-tax proposal would continue the favorable tax treatment of private pension plans and eliminate all of the nondiscrimi

---

[1] See Stephen A. Woodbury, *Employee Benefits and Tax Reform*, in this volume.
[2] Eric M. Engen and William G. Gale, *Comprehensive Tax Reform and the Private Pension System*, in this volume.
[3] See Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, CA: Hoover Institution Press, 1985).
[4] See David Cay Johnston, "A Flat Tax: Is It a Threat To Retirees' Security?," *New York Times*, July 9, 1995, p. F5.
[5] *Ibid.*
[6] See Employee Benefit Research Institute, *Retirement in the 21st Century. . . Ready or Not. .* (Washington, DC: Employee Benefit Research Institute, 1994).

nation rules and benefit limits. Thus, employers would be free to pick and choose which workers would be covered under their pension plans. Many employers will seize this opportunity to target their plans to those classes of employees they need to attract. The difficulty with this approach is that, while it may encourage employers to keep retirement plans for key personnel, it is also likely to result in a reduction in pension coverage for middle and lower income workers. Yet, this is exactly the group most at risk.

Conclusion

The result of these considerations is that I believe tax reform should not be pursued without a thorough analysis of all its potential effects, both positive and negative. If we decide to go forward with the type of reform that removes the relative tax advantages of employment-based plans, we must also consider a mandatory private retirement program. Inevitably, tax reform, retirement policy, and Social Security reform are all bound up together. We should not pursue one without carefully considering the interaction among all three.

6. An Economist's Perspective

by Stephen J. Entin

Introduction

There is a great difference between retirement saving policy and the appropriate tax treatment of saving for an efficient economy. These issues need to be addressed separately.

The federal tax code taxes income that is saved far more heavily than income that is used for consumption. As a partial remedy for the adverse economic consequences of that tax bias, the law gives relief from the extra tax burden to a limited amount of saving, that done through retirement plans. The treatment of retirement saving is also influenced by public policy concerns over how to ensure that people are able to take care of themselves in their old age, rather than relying on government assistance. The dual concerns underlying the peculiar tax treatment of retirement saving—economic efficiency and retirement income—confuse the two issues, and the resulting tax policy deals with neither very well.

The Tax Treatment of Saving

The federal income tax falls once on income used for consumption, except for a few items subject to small federal sales taxes. By contrast, income that is saved is taxed, and then the returns on the saving are taxed at both the corporate and individual levels (and may later be subject to estate and gift taxes). Neutral treatment of saving vis-a-vis consumption would remove the added layers of tax on saving. There would be no separate taxation of corporate income and capital gains over and above individual income taxation. Individuals would either receive a tax deferral for income saved, and pay tax on all the returns (as with pensions and individual retirement accounts (IRAs)) or pay tax on income before it is saved and then pay no tax on the returns (as with tax-exempt bonds). The major tax restructuring proposals would adopt one or the other neutral treatment for all saving. Individuals and the national economy would be better off if tax restructuring were adopted.

Some economists are skeptical that saving would rise if neutral tax treatment were adopted. They note that assets would build up faster tax deferred and speculate that people would simply cut back on their saving out of current income once they reach a "target" level of assets and retirement income. But unless the economic "Law of Demand" has been repealed, there will be more of a product, service, or asset if it becomes easier and cheaper to obtain. The concept of a targeted level of saving or retirement income is invalid. The target depends on the cost of obtaining retirement income. Relative to current law, people would have more reason to save, and more reason to hold assets, at every point in their lives.

Retirement Saving Policy

The pension industry owes part of its prominence to the fact that the tax system discourages people from saving through other financial vehicles. If all saving received neutral treatment on a par with pensions, there would be no tax reason for separate retirement saving plans or segregation of saving for emergencies, tuition, homebuying, and retirement into separate accounts. But this would mean more saving for retirement, not less, and is a good thing. (It might inconvenience the pension industry, but it is important to remember that the pension industry is a means to an end, not an end in itself.)

Some paternalistic policy officials fret that without a tax penalty on ordinary saving that favors pensions, and a tax penalty for early withdrawal of saving from retirement accounts, people would spend their money before retirement and have too little retirement saving and retirement income. In fact, the attempt to lock people into retirement accounts probably reduces retirement saving and total saving. People who cannot afford to save both for emergencies and for retirement avoid pensions and IRAs for fear they will not have access to their money if they need it. Meanwhile, their ordinary saving builds slowly because it is subject to repeated taxation.

There has been much discussion in the policy community about whether defined benefit or defined contribution plans are the less costly. If all saving were treated properly, policymakers would not need to ask the question. Individuals would choose their own saving vehicles, which might be ordinary savings accounts, mutual funds, brokerage accounts, IRAs, 401(k)s, or unrestricted, liberalized employment-based saving plans agreed upon by workers and employers.

Allowing people to control their own saving does not mean they would all have to become money managers. People can always get professional help. Neutral tax treatment of saving would create a great opportunity for the pension industry. There would be more total saving and more demand for saving vehicles. There might well be less demand for the types of restricted retirement pension plans or annuities than under current law, but there would be more demand for savings vehicles in general and more accumulated assets to be managed. If the pension industry is competitive and nimble, its market will expand, although it may have to sell a different product. Different kinds of annuities and insurance vehicles would emerge. Mutual funds would become even more popular.

Even if neutral treatment of saving were adopted, some people would not bother to save enough to keep themselves off public assistance in old age. This concern could be addressed by mandatory saving, preferably in connection with the privatization of Social Security. People would be required to set aside a portion of their payroll tax in individual retirement accounts, which they would own and direct. The current pension, insurance, and brokerage industries would act as custodians and managers of the accounts, as they do now for IRAs and pensions. The amounts would dwarf current pension plans and be a boon to the industry.

Even with mandatory saving, some people might have too low an income when young, due to lack of skills or frequent unemployment, to save enough for retirement. Their problem is one of poverty and should be dealt with through a specific means-tested welfare program.

Conclusion

People are capable of saving and taking care of themselves if given a chance and fair tax treatment. Policy officials should trust the public. Congress should adopt the economically correct tax treatment of saving, and then stand back and let people allocate their saving as they wish, guided by market forces. If there is a policy concern with the adequacy of retirement income, it should be dealt with separately, by mandatory saving linked to Social Security reform.

7. An Actuary's Perspective
by Robert Heitzman

Introduction

Will tax reform happen or not? Everyone is talking about tax reform, and there is no doubt a pervasive dissatisfaction with the tax code in its current form. Some kind of basic reform is likely, but it is impossible to predict at this point exactly what form it will take, or, for that matter, when it might happen. Most likely, it will be a patchwork quilt of concepts that will not satisfy any theorists but that will satisfy the demands of political expediency.

Whether some form of a consumption tax will emerge is therefore also difficult to predict. However, if it does—whether it is in the form of a value added tax, a national retail sales tax, a wage tax, or the USA tax proposed by Sens. Sam Nunn (D-GA) and Pete Domenici (R-NM) (which I suspect is co-sponsored by Gannett Publications)—I feel sure that it will be a further nail in the coffin of employment-based retirement plans. That will be true provided the new system substantively replaces our current income tax system and unless some special measures are included to subsidize such plans.

It has been many years since we have had a national discussion of the reasons that the tax code subsidizes employment-based benefits. The last discussion occurred before many of us were born, and our working lifetimes have witnessed instead a gradual unraveling of the clarity and value of that subsidy. Tax-favored benefits have been the favorite target of budget balancers, and without exception current reform proposals (even the Democratic versions) seem uniformly hostile to a continuing subsidy for employee benefits.

Current tax reform proposals have many common threads—simplification, lowering of marginal rates, fairness, etc.—but one strong theme is the desire to bolster our country's woefully inadequate savings rate. It would be ironic if implementation of the proposals had the effect of undermining what has been virtually our only success story in savings—employment-based retirement plans. During the 1980s, the increase in assets held under such plans was greater than the increase in household wealth in the United States. Without these plans, we would have had a negative savings rate during that decade.

The Effect of Tax Reform Proposals on Employment-Based Retirement Plans

Why would the adoption of a consumption tax threaten employment-based retirement plans? Employers adopt these plans for many reasons: the desire to provide a smooth transition out for older workers, the efficiency of group administration and risk-sharing, and so on. However, as those of us who have been involved in benefits consulting know well, the tax subsidy accorded to qualified plans has been a major factor. That has been the only obstacle in the way of the increasing focus on supplemental executive retirement plans, top-hat schemes, and rabbi and secular trusts that we have seen during the last decade.

The problem is not that a consumption tax approach takes anything away from the beneficial tax treatment that qualified plans now receive. Rather, the problem is that equivalent benefits are extended to all forms of savings. Why would someone accept all of the constraints and compliance hoops associated with a qualified plan when the equivalent tax treatment is available, for example, simply by depositing money into a mutual fund with no strings attached?

That point is evident in the case of the USA tax, where all amounts set aside as savings are immediate offsets to the tax base (the treatment now reserved for qualified plans). In the case of a wage tax, where the "tax prepayment" approach is utilized for nonqualified savings but investment earnings are never taxed, it can be demonstrated mathematically that qualified plans have no real comparative advantage.

Much of the discussion about consumption taxes confuses two separate issues—the issue of our nation's savings rate and the issue of our national retirement income policy. For example, James Poterba observed that the academic world is not sure whether the nondiscrimination rules have the net effect of increasing coverage under qualified plans. On the one hand, they require a wider breadth of coverage; on the other, they inhibit the formation of new plans because of the compliance hurdles they pose. I accept Mr. Poterba's doubts, but I think he is addressing the question of total savings, as opposed to the issue of breadth of coverage. I think even the academic world would accept the proposition that the nondiscrimination rules promote more coverage of lower income groups under qualified plans, once an employer decides to adopt such a plan.

Addressing the first issue will not necessarily benefit the second. Let us hypothetically accept that a move to a consumption tax would increase savings overall. The result would be an increase in the pool of capital available for investments, which, according to economic theory, would make us more efficient and better able to compete internationally. That would be a positive outcome for the nation and make it more likely that our society will be able to survive the demographic time bomb represented by the baby boomer cohort.

However, the increase in savings would likely be concentrated among the affluent. Rank-and-file workers do not save adequately because they lack the resources, not because of the presence or absence of tax incentives. They need all of their current income just to feed and house their families and educate their children. Many of them look to employment-based retirement plans to subsidize the near subsistence-level benefits of Social Security.

Conclusion

Before we create an environment that would lead to the demise of these plans, let us make sure we have a contingency plan in place.

8. An International Experience Following Comprehensive Tax Reform

by Giles C. Archibald

Introduction

The debate on the appropriate tax treatment of employee benefits is an international debate. This is a review of what has occurred in New Zealand, Australia, and other countries.

Pensions

The New Zealand Experience

Prior to 1990, New Zealand offered a typical tax environment for pension plans:

- Employer contribution: deductible
- Employee contribution: deductible
- Investment income: tax free
- Benefits: taxable as income

In other words, in typical manner, the tax was back-end loaded.

The advantage over individual savings was clear. To emphasize the point: If, over a 30-year career, an employer paid an employee $1,000 per year and the net amount was invested, under certain reasonable assumptions the amount available at retirement could purchase a net pension of $5,745 annually. However, if the employer invested the same amount in the tax-protected environment of a pension plan, the net pension payable at retirement would be $9,530. This represents a substantial tax incentive.

In 1990, the New Zealand government decided to remove this distinction in tax treatment. Pension plans are now taxed as follows:

- Employer contribution: tax deductible but 33 percent of the contribution is paid as tax
- Employee contribution: not tax deductible
- Investment income: taxed at 33 percent
- Benefits: tax free

Under this scenario, the tax is front-end loaded. There were two immediate consequences of this change in treatment:

- The government increased its tax take with respect to retirement benefit contributions but suffered a reduction in taxes on pensions in payment.
- Most (but not all) companies cut back their retirement benefit formula for future service and probably around one-half also made some retroactive changes that included pensions in payment, so that the net benefit remained more or less unchanged.
- Pensioners and employees close to retirement whose benefits were not reduced enjoyed a windfall, in that their benefit was now tax free.
- Some defined benefit plans converted to defined contribution.

A longer term consequence was a fall in the number of retirement plans (table 8.1).

Table 8.1
Number of Retirement Plans and Members

Year	Number of Plans[a]	Number of Members
1987	4,585	507,000
1988	4,989	541,000
1989	4,553	511,000
1990	2,864	508,000
1991	2,517	528,000
1992	2,188	540,000
1993	1,935	582,000
1994	1,755	614,000

Source: Giles C. Archibald
Note: Some "individual plans" are similar to mutual funds and have multiple participants.
[a]Individual and employment-based.

Employment-based plans did not decrease so dramatically (table 8.2)

Table 8.2
Number of Employment-Based Plans

	1990	1994
Defined Benefit	452	318
Defined Contribution	1,790	1,121

Source: Giles C. Archibald

It is believed that the number of employees in employment-based retirement plans has fallen slightly since 1990. It is also our view there are now significantly fewer employees in company-sponsored plans than there would have been had the tax laws not changed.

Interestingly though, the funds under management have continued to climb (table 8.3).

Table 8.3
INCREASE IN FUNDS UNDER MANAGEMENT

Year	Funds (NZ$ Billion)	Consumer Price Index[a] 1985 Base	Real Gross Domestic Product Growth Rates[a] (%)
1987	$10.3	131.0	-0.7%
1988	10.9	139.4	3.9
1989	11.1	147.3	-1.4
1990	11.0	156.3	0.1
1991	11.0	160.4	-3.7
1992	11.3	161.9	0.3
1993	12.4	164.1	5.5
1994	14.0	166.9	4.4

[a]Source: International Financial Statistics and OECD Economic Outlook.

In summary, there was a decline in employment-based retirement benefits, particularly among the smaller companies.

Several companies moved to a total remuneration approach. Employees determine how much and when to save for retirement.

Australia

Australia has also changed its taxation of retirement programs. Currently,

- Employer contribution: tax deductible but subject to 15 percent tax in the fund.
- Employee Contribution: not tax deductible
- Investment Income: taxable at 15 percent (effective tax rate usually lower, depending on asset mix)
- Benefits (lump sum): taxed favorably at retirement, e.g., for a middle manager, a lump sum of A$400,000 (assuming all employer financed) might only be taxed at 13 percent.

(The lump-sum benefit taxation is shown because benefits are invariably taken as lump sums in Australia.)

It is difficult to assess the impact of this change on the Australian retirement scene because, at about the same time, the government and the unions came to an agreement mandating employment-based retirement benefits for all employees.

Other Countries

Many governments have shown interest in changing the tax environment of pension plans.

- Several years ago, Ireland levied a one-time tax on pension assets.
- Denmark partially taxes real investment return.
- Canada and the United Kingdom have increasingly limited the tax-favored benefits available from retirement plans, effectively to restrict tax benefits to the wealthy.
- Spain has restricted how tax-favored pensions can be provided.

However, at the same time:

- The aging of the population gives more voter power to retirees.
- Civil servants are often well favored by retirement plans.
- Social security provision is being reduced.
- There is a concern that if retirement plans are not tax favored, the number of plans will decrease, thus placing the burden of support back onto the state.

As a result:

- We have seen, in certain countries, tax changes that encourage a wider participation in retirement savings.
- Governments have been diffident about following the lead of Australia and New Zealand.

MEDICAL PROVISION

Outside of the United States, the majority of the health care is delivered through the public sector, at a much lower cost (as percentage of Gross Domestic Product) than in the United States (table 8.4).

Table 8.4
HEALTH CARE EXPENDITURES AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT, SELECTED COUNTRIES, 1992

Australia	8.8%
Canada	10.3
Germany	8.7
Japan	6.9
United Kingdom	7.1
United States	13.6

Source: Organization for Economic Cooperation and Development.

However, health expenditures are growing. All of these countries experienced real expenditure growth over 1980–1992. This trend is common to almost all developed countries.

There certainly is an interest in increasing private provision. Medical plans are or are becoming popular supplements to mandated provision in many countries, including Belgium, Brazil, Canada, France, Mexico, Singapore, Spain, and the United Kingdom.

Not all of these countries totally tax favor the programs; for example, in the United Kingdom the premium is taxable income for the employee.

The taxation treatment of medical premiums has been of little consequence in terms of the popularity of these arrangements because of the relatively low level of premiums/tax, the high perceived value to the employee, and the clear advantage of bulk purchase by the employer.

Medical benefits are very rarely continued post retirement. In no major country is such continuation common practice, apart from possibly Canada.

Conclusion

In conclusion, it does appear, from the limited experience of New Zealand, that the tax treatment of pension plans can significantly affect the number and type of retirement programs. However, the same may not be true of medical plans.

Additionally, while governments have acted to limit the tax advantages of pension plans for the highly paid, there is no evidence of any countries wishing to follow the example of New Zealand.

9. Employee Benefits and Tax Reform

by Stephen A. Woodbury

INTRODUCTION

The current tax treatment of pensions and health insurance in the United States is a hybrid that lacks consistency under either an accrual income tax system or a consumption tax system. Under an accrual income tax, employer contributions to pension plans represent an addition to wealth that would be taxed at the time they are made. The interest earned on pension contributions also represents an addition to wealth that would be taxed annually. When a worker retires, all applicable taxes would already have been paid on the benefit, and the flow of retirement income received by the worker would not be taxed. Similarly, employment-based health insurance arguably represents a current benefit that, under the income tax, should be taxed annually as current income.[1]

Under a consumption tax, things are different for pensions. The idea of the consumption tax is to tax what an individual takes out of the system. Since pension contributions represent saving, they are not taxed when they are made. Neither is the interest earned on pension contributions taxed under a consumption tax, since it is reinvested and accumulated. Only when the worker retires and starts to draw retirement income are pension contributions taxed. And only the portion of the retirement income that is consumed is taxed—if only one-half is consumed, taxes are paid only on that half.

Although pensions fare better under a consumption tax than under an income tax, it is unclear whether health insurance would, too. If health insurance expenditures are considered current consumption (as most economists believe they should be), the same tax that applied to any other consumption would apply to employer contributions to health insurance. On the other hand, one could argue (as in footnote 1) that health insurance is a merit good and medical expenditures are unfortunate, so that both pensions and health insurance should be excluded from the definition of consumption.

The existing tax treatment of employee benefits in the United States is a hybrid because we nominally have an income tax under which employer contributions to both pensions and health insurance could be taxed as income. But both receive favorable tax treatment—pensions are tax favored in that current pension contributions and interest on previous contributions go untaxed, and health insurance contributions are tax free. The tax treatment of pensions is consistent with a consumption tax, not an income tax, and the prevailing view among economists is that the tax treatment of health insurance is consistent with neither.

Current attempts to move toward a consumption tax have been welcome by most economists both because most subscribe to the basic claims that are made for the consumption tax—increased saving, improved economic growth, and greater efficiency—and because the consumption tax promises to bring greater coherence to a system that, despite improvements during the last 15 years, still has some basic inconsistencies.

However, major concerns with the consumption tax have been raised by many employers who are comfortable with the existing tax treatment of employee benefits and less obsessed than economists with the notion of allocative efficiency or with making the tax system conform to a consistent theory of taxation. Employers—especially employers of skilled labor—have at least two reasons for wanting to provide employee benefits and accordingly find the favorable tax treatment of benefits attractive (Rosen, 1996). First, the provision of employee benefits may have externalities that enhance the workers' productivity. For example, employers may want to ensure that their workers have good access to health care so that they are more likely to stay healthy. And they may want to provide pension benefits to workers to relieve workers of the burden and worry of planning and providing for retirement. Second, benefits provide a way for employers to create a bond between the firm and the worker. Such a bond and the commitment between the worker and firm that is implied are especially important in firms where workers have (or need to acquire) a significant amount of firm-specific human capital. Employers, who must bear most or all of the

[1] As Bradford (1986) has noted, there may be a case for excluding medical expenditures from the definition of accrual income if we believe that medical expenditures are unfortunate and do not contribute to utility. Similarly, if health insurance were defined as a merit good, then we might want to exclude health insurance contributions from the definition of accrual income, as is now done with employer contributions to group health insurance. However, considerations of efficiency, first articulated by Feldstein (1973), argue for including employer contributions to health insurance in the income tax base.

cost of investing in firm-specific training, can reap the returns to their investment only if workers remain with the firm over a long period of time.

The importance of these two effects has not been quantified convincingly, although there is some evidence that the latter is important (see, for example, the review by Hutchens (1989), or the evidence presented by Topel (1991)). However, existing evidence suggests that the loss of favorable tax treatment of employee benefits would make it more costly for employers to provide benefits and could indeed lead to social costs in the form of broken job matches that efficiency considerations would suggest should have continued.

This discussion briefly considers the essential features and implications for employee benefits of some of the tax reform proposals that were introduced during the 104th Congress and promise to be considered further in the future. It then presents some estimates of how these comprehensive tax reforms would affect the coverage of workers by employment-based pension and health insurance plans, employer contributions to pension and health insurance plans, and the shares of compensation received as pensions and health insurance.

Proposals to Change the Tax Treatment of Employee Benefits

A common feature of recently proposed tax reforms is the elimination of the tax advantage that has long been enjoyed by employer contributions to employee benefit plans. The proposals eliminate this tax-favored status by either of two approaches. The first is to move toward a consumption tax under which savings are untaxed regardless of whether they are in the form of qualified pension savings (so that there is no longer a tax advantage to saving through an employer-based retirement plan) and employer contributions to health insurance are considered consumption and hence taxed. Several such proposals were introduced during the 104th Congress, including the so-called USA tax proposal of Sens. Sam Nunn (D-GA) and Pete Domenici (R-NM) and flat tax proposals introduced by Rep. Dick Armey (R-TX) and Sens. Richard Shelby (R-AL) and Arlen Spector (R-PA). All have the essential features of a consumption tax (Salisbury, in this volume; Heitzman 1995; Gruber and Poterba, 1996).

The second approach would be to tax employer contributions to pension and health insurance plans in the year they are made under the existing personal income tax. This is a proposal that has had at least one vocal advocate for some years (Munnell, 1989) and is included in Rep. Richard Gephardt's (D-MO) so-called progressive flat-tax, which retains most of the basic features of the existing tax system but broadens the tax base to include employer contributions to pension and health insurance plans[2] (Gruber and Poterba, 1996).

The economic incentives created by eliminating the tax-favored status of employee benefits on employment-based pensions are clear. A consumption tax would place all saving on the same footing and would remove the tax-favored position of contributions to an employment-based pension plan compared with other forms of saving. A dollar not consumed would not be taxed in the current year, whether it was contributed to a pension plan or deposited in any other instrument of saving. It follows that the pure tax incentive for workers to receive compensation in the form of pension contributions would be removed, and that, over time, as labor markets adjusted to the new situation, pension contributions and coverage would fall. Similarly, taxing employee contributions to health insurance would remove the tax incentive for workers to demand such benefits and would reduce health insurance contributions and coverage.

Impacts of Tax Reform on Employee Benefit Provision

Table 9.1 shows the results of some simulations that suggest how removing the tax-favored treatment of employee benefits would alter three measures of employee benefit provision: the percentage of wage and salary workers (aged 25 and over) who are covered by employment-based pension and health insurance plans, the aggregate dollar contributions by employers to pensions and health insurance plans, and the share of total compensation received by workers as pensions and health insurance.[3]

Column 1 of table 9.1 shows actual *levels* of employee coverage, employer contributions, and compensation shares in 1993–1994—i.e., under the existing income tax in which pension plan contributions are tax deferred and health insurance contributions are tax free. Columns 2, 3,

---

[2] See Dallas L. Salisbury, "Tax Reform and Employee Benefits," in this volume.

[3] The simulations presented in table 9.1 assume that the deductibility of employer contributions under payroll and corporation income taxes would be preserved under any tax reform. I know of no estimates that would provide a way of estimating the impacts of changing the tax treatment of benefits under payroll and corporation income taxes.

Table 9.1

SIMULATED CHANGES IN EMPLOYEE BENEFIT COVERAGE, EMPLOYER CONTRIBUTIONS TO BENEFIT PLANS, AND COMPENSATION SHARES UNDER VARIOUS TAX REFORMS, 1993–1994 (ESTIMATED SIMULATION ERROR IN PARENTHESES)[a]

	(1)	(2)	(3)	(4)	(5)
Tax Treatment of Employer Contributions					
To pension plans:	Deferred	Deferred	Deferred	Taxable	No Advantage
To health insurance plans	No Tax	Low tax cap	Taxable	Taxable	Taxable
Employee Coverage[b] (%):					
Pensions	57.0	–0.1	–0.3	–6.2	–5.5
	(—)	(0.1)	(0.2)	(2.7)	(2.3)
Health insurance	67.8	–0.8	–2.6	–3.1	–2.3
	(—)	(0.7)	(2.1)	(2.3)	(2.0)
Employer Contributions[c] (in $ billions) to					
Pensions	87.7	–1.5	–3.8	–42.8	–33.9
	(—)	(.6)	(1.8)	(6.7)	(6.8)
Health insurance	263.0	–22.9	–38.7	–52.9	–31.8
	(—)	(1.7)	(5.0)	(9.9)	(8.5)
Share of Total Compensation[c] (%):					
Pensions	2.4	0.0	-0.1	–0.9	–0.8
	(—)	(.1)	(.1)	(.2)	(.2)
Health insurance	7.3	0.1	0.1	0.0	0.1
	(—)	(.1)	(.2)	(.3)	(.3)

Source: Simulations based on estimates reported in Stephen A. Woodbury and Douglas R. Bettinger, "The Decline of Fringe-Benefit Coverage in the 1980s," in R.W. Eberts and E.L. Groshen, eds., *Structural Changes in the U.S. Labor Markets: Causes and Consequences* (Armonk, NY: M.E. Sharpe, 1991); and Stephen A. Woodbury and Wei-Jang Huang, *The Tax Treatment of Fringe Benefits* (Kalamazoo, MI: W.E. Upjohn Institute, 1991).

Note: Column (1) gives actual benefit coverage, employer contributions, and compensation shares in the most recent available year (1993 or 1994). Columns 2 through 5 show the simulated *changes* that would result from changing the tax treatment of benefits as shown in the column headings. Columns 2, 3, and 4 show the impacts of reforms occurring under the existing income tax: Column 2 gives the effects of a low tax-cap on health insurance contributions, column 3 gives the effects of taxing all employer contributions to health insurance, and column 4 gives the effects of taxing all employer contributions to both pensions and health insurance, all under the existing income tax. (The last of these proposed changes is the Gephardt proposal.) In contrast, column 5 gives the effects of replacing the existing income tax with a consumption tax that treats employer contributions to health insurance as consumption (as in the Nunn-Domenici USA Tax proposal and the Armey-Shelby-Spector flat tax proposals).

[a]Adding the estimated simulation error to the point estimate gives the *upper bound* of the 95 percent confidence interval around the point estimate, and subtracting the estimated simulation error from the point estimate gives the *lower bound* of the 95-percent confidence interval. See the text for further discussion.

[b]Coverage figures are for 1993. See Employee Benefit Research Institute, *EBRI Databook on Employee Benefits,* Third edition (Washington, DC: Employee Benefit Research Institute, 1995); and Sarah Snider and Paul Fronstin, "Sources of Health Insurance and Characteristics of the Uninsured," *EBRI Issue Brief* no. 158 (Employee Benefit Research Institute, 1995). Coverage is defined as the percentage of wage and salary workers (aged 25 and over who had earnings in the previous year) included in an employment-based pension or group health insurance plan.

[c] Employer contributions and shares of total compensation are for 1994. See *Survey of Current Business* 76 (January/February 1996).

and 4 show how these measures of benefit provision might *change* under three changes to the existing income tax. In column 2, pension plan contributions are still tax deferred but health insurance contributions above a relatively low "cap" are taxed as income. The tax cap simulated in column 2 is $1,750 (current dollars), which is approximately the cost of annual catastrophic health insurance coverage. In column 3, pension plan contributions remain tax deferred but *all* health insurance contributions are taxed as income. In column 4, all employer contributions to pension plans and to group health insurance are taxed as income, as would occur under Rep. Gephardt's proposed reforms of the income tax.

Finally, column 5 shows simulations of the changes that would occur under a consumption tax. Here, pension contributions have no tax advantage over other forms of retirement saving. Also, health insurance contributions are taxed as consumption. This is essentially the tax treatment of employee benefits that has been proposed by Sens. Nunn and Domenici in their USA tax and by Rep. Armey and Sens. Shelby and Spector in their flat tax proposals.

Each of the simulated changes in table 9.1 should be thought of as a point estimate that has some error and uncertainty associated with it. Accordingly, each point estimate in the table is accompanied by an estimated simulation error in parentheses.[4] Each error estimate can be used to construct the 95 percent confidence interval for the simulated change in question. Adding the error estimate to the point estimate gives the *upper bound* of the 95 percent confidence interval, and subtracting the error estimate from the point estimate gives the *lower bound* of the 95 percent confidence interval. For example, the simulated reduction in pension coverage that would follow a move to a consumption tax is 5.5 percentage points (see column 5). This point estimate has a simulation error of 2.3 percentage points associated with it, yielding a 95 percent confidence interval of 3.2 percentage points to 7.8 percentage points. In the following discussion, each point estimate is reported with its simulation error in parentheses—e.g., the decrease in pension coverage that follows adoption of a consumption tax is reported as "5.5 percentage points (±2.3 percentage points)."

Two types of simulation underlie the estimates in table 9.1. The simulated changes in employee coverage (the first two rows) were obtained by taking behavioral estimates of the responsiveness of employee benefit coverage to changes in marginal income tax rates and applying these behavioral estimates to 1993 employee benefit coverage data. The behavioral estimates were obtained by estimating coverage equations for pensions and health insurance using the 1988 Current Population Survey and supplemental data sources (Woodbury and Bettinger, 1991). The coverage equations used workers aged 25 and over as the unit of observation and included among the explanatory variables a measure of the tax price of employee benefits, which in turn was based on the marginal tax rate faced by a worker under federal and state income taxes. The higher the marginal tax rate faced by a worker, the lower the tax price of employee benefits and the greater the incentive to receive compensation in the form of pensions and health insurance. The estimates used in these simulations suggest that a one percentage point increase in the marginal tax rate increases benefit coverage by about 0.24 to 0.30 percentage points for pensions and by about 0.1 to 0.13 percentage points for health insurance.[5] The coverage simulations are discussed further in the following section on Effects on Employee Coverage.[6]

The simulated changes in employer contributions to pensions and health insurance (the middle two rows of table 9.1) and the simulated changes in the share of total compensation received as pensions and health insurance (the bottom two rows) were obtained from a consumer theoretic model and behavioral estimates that take account of the possibilities for substitution among wages, pension benefits, and health insurance benefits. (The model and estimates are described in detail in Woodbury and Huang, 1991). The behavioral estimates were applied to 1994 data on employer contributions and benefit compensation shares from the National Income and Product Accounts (*Survey of Current Business,* January/February 1996). The estimates underlying these latter simulations are based on a complete system that allows interaction among the demands for wages, pensions, and health insurance, so that treating employer contributions to group health insurance as taxable can lead to changes in the demand for pensions as well as to changes in the demand for health insurance, even without any income effects. (This could not occur in the coverage simulations, which are based on a simpler estimating procedure.) The employer contribution and compensation share simulations are discussed in the section on Effects on Employer Contributions and Compensation Shares.[7]

[4] The source of uncertainty considered in constructing the error estimates is error (or uncertainty) in the behavioral estimates that underlie the simulations. A larger error associated with an underlying behavioral parameter leads to a larger simulation error. In some cases, more than one behavioral parameter is used to obtain a simulated impact, and the error associated with the simulated impact is larger as a result. In constructing these simulation error estimates, one could also consider error in the estimated changes that drive the simulated changes in question. For example, there is error associated with the estimated change in marginal tax rates that would accompany any tax reform. I have not attempted to incorporate this latter source of error in the simulation error estimates reported in table 9.1.

[5] Reagan and Turner (1994) have produced similar results for pension coverage, also using Current Population Survey data but using a somewhat different specification of the tax-price variable. Their results suggest that a one percentage point increase in marginal tax rates leads to a .4 percentage point increase in pension coverage for men and to a somewhat smaller increase in pension coverage for women.

[6] The coverage simulations also allow for income tax reform to affect pension and health insurance coverage through changes in disposable income. These changes in disposable income that accompany income tax reform were simulated in Woodbury and Huang (1991). I assume that moving to a consumption tax would be revenue neutral and hence would have no income effects (see the next footnote).

[7] The differences between the simulated changes under a reformed income tax (table 10.1, columns 2, 3, and 4) and the simulated changes under the consumption tax (column 5) stem from assumptions that I have made about how a reformed income tax and a newly implemented consumption tax would affect household incomes. Specifically, I assume that removing the tax-favored treatment of employee benefits under the income tax would reduce disposable incomes by broadening the tax base without reducing tax rates—i.e., there would be an increase in taxes paid by households under the reformed system. In contrast, I assume that moving to a consumption tax would not reduce disposable incomes because income reductions that would result from the loss of tax-favored treatment of benefits would be compensated by reduced tax rates (and possibly by the increased

Effects on Employee Coverage

The rows of table 9.1 labeled Employee Coverage show, first, that 57 percent of wage and salary workers in 1993 were covered by an employment-based pension plan and that nearly 68 percent were covered by employment-based group health insurance. The simulations displayed in columns 2 and 3 show the results of taxing (partially or fully) health insurance contributions but leaving pension contributions untaxed. The simulation in column 2 suggests that a low annual tax cap of $1,750 on health insurance contributions would have reduced health insurance coverage by 0.8 percentage points (±.7 percentage points). The simulation in column 3 suggests that including all health insurance contributions in the income tax base in 1993 would have reduced health insurance coverage by 2.6 percentage points (±2.1 percentage points).

Column 4 simulates the effects of the income tax reforms proposed by Rep. Gephardt, in which all pension and health insurance contributions are taxed as income. These simulations suggest that taxing both pension and health contributions as income in 1993 would have reduced pension coverage by 6.2 percentage points (±2.7 percentage points) and would have reduced health insurance coverage by 3.1 percentage points (±2.3 percentage points).

Finally, column 5 simulates the effects of implementing a consumption tax (in which pensions are no longer tax favored and health insurance contributions are taxed as consumption). These simulations suggest that, if a consumption tax had been in place in 1993, pension contributions would have been lower by 5.5 percentage points (±2.3 percentage points) and health insurance contributions would have been lower by 2.3 percent (±2.0 percentage points).

Clearly, both pension and health insurance coverage would suffer if pension and health insurance contributions were taxed (as under the Gephardt proposal) or if a consumption tax were adopted. Also, pension coverage would suffer more than would health insurance coverage both in absolute and relative terms. The greater drop in pension coverage occurs because the estimates underlying the simulations suggest that the tax price elasticity of demand for pensions exceeds the tax price elasticity of demand for health insurance, a result that makes sense in light of the fact that pensions are essentially deferred cash whereas health insurance is in-kind compensation. The reductions in pension and health insurance coverage are not to be sneezed at—a one percentage point reduction in employee benefit coverage means that about 1.25 million fewer workers would be covered by a benefit. So the 5.5 percentage point reduction in pension coverage implies that nearly 7 million fewer workers would be covered by an employment-based pension, and the 2.3 percentage point reduction in health insurance coverage implies that nearly 3 million fewer workers would be covered by employment-based health insurance. Although significant, these reductions do not suggest that sweeping tax reform would demolish the voluntary pension and health insurance systems. Even the gloomiest simulations suggest that if all employer contributions to employee benefits were taxed under the income tax, about 48 percent of all workers would remain covered by an employment-based pension plan, and over 64 percent would remain covered by an employment-based health plan.

Employers suggest that they would curtail their provision of benefits far more dramatically than do the coverage simulations reported in the top to rows of table 9.1. What are we to believe? There are two weaknesses inherent in the behavioral estimates that are the basis of the simulations reported in this table. First, they amount to out-of-sample forecasts or extrapolations that may be unreliable. Second, the behavioral responses on which they are based were obtained using data that are now between 8 years and 14 years old, and it is possible that behavior has changed or that exogenous changes have occurred that would make these estimated behavioral responses inaccurate today.

On the other hand, employers may or may not be good predictors of how they would react to changes in the tax treatment of benefits. Moreover, employers have an interest in retaining the existing tax treatment of benefits and may overstate their negative reaction to loss of that tax-favored treatment in order to keep lawmakers from changing a policy from which they believe they benefit. So, although the coverage simulations may underestimate the reductions in benefit coverage that would follow loss of tax-favored treatment, employers' protestations may overstate these reductions. There is, of course, a middle ground:

growth that advocates of the consumption tax promise). In large part, these assumptions are based on political considerations; i.e., the fact that advocates of broadening the base of the income tax to include employee benefits see a need to increase federal revenues in order to balance the budget, whereas advocates of the consumption tax appear committed to deficit reduction through reductions in federal spending. The assumptions, then, are that broadening the tax base of the income tax to include employee benefits would not be revenue neutral but that moving to a consumption tax would be revenue neutral. Neither assumption is necessary, and the differences between columns 4 and 5 show the differences between tax reforms that are and are not revenue neutral. The effects of tax reforms on employee benefits under various assumptions about income effects and revenue neutrality are discussed in Woodbury and Huang (1991).

Although favorable tax treatment has greatly enhanced the coverage of workers by benefits, favorable tax treatment is not solely responsible for employer provision of benefits. It follows that removing the tax-favored treatment of benefits would significantly reduce benefit coverage without wholly eliminating it.

Effects on Employer Contributions and Compensation Shares

The middle rows of table 9.1 show employer contributions (in $ billions) to pension and group health insurance plans. Column 1 shows that, in 1994, employer contributions to pension plans totaled $87.7 billion, and employer contributions to group health insurance totaled $263 billion. These contributions imply that 2.4 percent of the total compensation of workers was made up of pension contributions, and 7.3 percent was made up of health insurance contributions (see the "share of total compensation" figures in the bottom rows of table 9.1).

The simulations displayed in column 2 show the results of imposing a low tax cap on health insurance contributions but leaving pension contributions untaxed. The simulations suggest that this policy would reduce employer contributions to health insurance by about $22.9 billion (±$1.7 billion), or about 9 percent, and would reduce pension contributions by a relatively small amount. Also, the relative shares of pensions and health insurance in total compensation would remain unchanged (bottom rows of column 2).

Taxation of all employer contributions to health insurance (with pensions still untaxed) would result in a larger reduction in health insurance contributions, as shown in column 3. Health insurance contributions would fall by about $38.7 billion (±$5.0 billion), or about 15 percent, and pension contributions could also fall somewhat. The relative shares of pensions and health insurance in total compensation would change only slightly (see the bottom rows of column 2).

Column 4 simulates the effects of including all employer contributions to employee benefits in the income tax base (the Gephardt proposal). The simulations suggest that making pension and health contributions taxable would reduce employer contributions to pension plans by $42.8 billion (±$6.7 billion), or nearly 50 percent, and would reduce employer contributions to health insurance by $52.9 billion (±$9.9 billion), or about 20 percent. Also, the share of pensions in total compensation would fall by nearly a percentage point, to just 1.5 percent.[8]

Finally, column 5 simulates the impact of a consumption tax under which employer contributions to health insurance are treated as consumption (the Nunn-Domenici and Armey-Shelby-Spector proposals). The consumption tax removes the tax advantages of receiving compensation as pensions, so employer contributions to pension plans drop—the simulations suggest that they would have dropped by $33.9 billion (±$6.8 billion), or nearly 40 percent in 1994. Also, employer contributions to health insurance would have dropped by $31.8 billion (±$8.5 billion), or by about 14 percent.

Clearly, taxing all employer contributions to employee benefit plans under the income tax (the Gephardt proposal) or moving to a consumption tax under which health insurance contributions would be treated as consumption (the Nunn-Domenici and Armey-Shelby-Spector proposals) would dramatically reduce employer contributions to pensions and health insurance. Would the effects of these changes on the workers' well-being be equally dramatic? In the case of pension benefits, the question turns on whether there would be alternative retirement saving vehicles and whether workers would replace the lost pension savings with other forms of saving. If pension contributions were taxed under the income tax (the Gephardt proposal), there would be no alternative retirement saving vehicle: Once pension contributions were taxed as current income, the most attractive retirement saving vehicle available to most individuals would be gone. This suggests that net savings could fall significantly if pension contributions were taxed as income. In contrast, under a consumption tax, savings of any kind would go untaxed, so workers could (perhaps reasonably) be expected to save enough to provide for their own retirements. In effect, they could do for themselves what they had previously needed an employer to do for them—gain access to a tax-favored vehicle for retirement saving. The ready availability of tax-favored retirement saving to all workers, not just to those employed and covered by an employment-based plan, suggests that the implications of the consumption tax for the distribution of retirement income could be salutary.[9]

Available empirical evidence gives some indication of whether workers would in fact save and provide ad-

[8] The share of health insurance would remain roughly constant even though expenditures would fall, because of the drop in pension contributions.

[9] There are, of course, tax-favored vehicles for retirement saving now available to the self-employed (Keogh plans) and to workers who are not covered by an employment-based plan and whose earnings are within certain limits (individual retirement accounts). But access to these vehicles is less simple than access to tax-deferred saving would be under a consumption tax.

equately for retirement in the face of declining pension contributions. The review by Gale (1995) suggests that early estimates of how pensions affect saving tended to overstate the degree to which pension contributions represented new saving. His estimates suggest that between 20 percent and 60 percent of pension contributions represent net additions to saving (as opposed to 80 percent to 100 percent, as many earlier studies found). In other words, reductions in pension contributions would reduce net retirement savings substantially—by 20 percent to 60 percent of the reduction in total pension contributions—but by less than 100 percent.

But existing empirical evidence on how pensions affect saving probably tells us little about how moving to a consumption tax would affect net saving; all the existing evidence has been derived from a setting in which pensions are tax favored and other forms of saving are not tax favored. Under the consumption tax, savings of any sort would be tax favored, suggesting that decreases in employer contributions to pension plans would result in a less significant decline in net saving than would be suggested by Gale's summary estimate. Indeed, it is possible that, under a move to a consumption tax, there would be no net decrease in savings despite significant reductions in employer contributions to pension plans. Nevertheless, it seems fair to conclude that whether workers would save and provide for retirement to the extent that employment-based pensions plans now do remains an open and potentially troubling question.

If net saving did fall in the wake of the loss of tax-favored treatment of pensions, then in the long run the reformed system would have serious costs, both private (to those who failed to save adequately) and public (if the resulting low retirement incomes were perceived as a problem requiring a public response in the form of income transfers and an expanded Social Security system). Taxing employer contributions to pensions under the income tax, for example, would seem to be an almost certain recipe for an expanded Social Security system.

Health insurance benefits would also become less generous under the proposed tax reforms, suggesting a shift toward more basic health insurance, with greater emphasis on true insurance and less on tax-free health benefits. Most observers would see this as a positive development—a health care sector bloated by favorable tax treatment has long been criticized by economists. However, Gruber and Poterba (1996) have recently questioned the extent to which removing the tax-favored treatment of employment-based health care can be expected to stem the growth of the health care sector.

As previously mentioned, these simulations, like all simulations, need to be taken with the usual grain of salt. They represent extrapolations based on behavioral estimates that derive from data that are 8 years to 14 years old and have a sizable degree of uncertainty associated with them (as reported in table 9.1). But the nature of simulation is to make the best of an imperfect situation in order to provide informed impressions about the impacts of alternative policies.

Summary

The story told by the simulations shown in table 9.1 is rather simple: Taxing all employer contributions to employee benefit plans under the existing personal income tax, or moving to a consumption tax in which pensions are no longer tax favored and in which health insurance contributions are considered consumption, would reduce pension coverage by between 3 percentage points and 9 percentage points and health insurance coverage by between 0.5 percentage points and 5.5 percentage points. These reductions are significant but by no means apocalyptic, although many employers would say that they are underestimates of the reductions that would occur. Much larger reductions (in proportional terms) would come in the dollar amounts that employers contribute to pensions and health insurance: The simulations suggest that under a consumption tax, pension contributions would fall by nearly 40 percent and health insurance contributions would fall by nearly 15 percent. And if employer contributions to pensions and health insurance were included in the income tax base, pension contributions would fall by nearly 50 percent and health insurance contributions would fall by about 20 percent. Together, the findings that coverage would be reduced somewhat while contributions would fall dramatically (especially for pensions) suggests that employment-based pension and health insurance plans, while still available to roughly one-half or more of all workers, would be far less generous under a consumption tax than they have been (and similarly if benefits were taxed under the existing income tax). To a far greater extent than in the past, it would be up to workers to save for retirement and to pay directly for their own health care.

References

Bradford, David F. *Untangling the Income Tax*. Cambridge, MA: Harvard University Press, 1986.

Employee Benefit Research Institute. *EBRI Databook on Employee Benefits*. Third edition. Washington, DC:

Employee Benefit Research Institute, 1995.

Feldstein, Martin S. "The Welfare Loss of Excess Health Insurance." *Journal of Political Economy* 81 (March/April 1973): 251–280.

Gale, William G. "The Effects of Pensions on Wealth: A Re-Evaluation of Theory and Evidence." Draft manuscript. Washington, DC: The Brookings Institution, 1995.

Gruber, Jonathan, and James Poterba. "Fundamental Tax Reform and Employment-based Health Insurance." In Henry Aaron and William Gale, eds., *Economic Effects of Fundamental Tax Reform*. Washington, DC: The Brookings Institution, 1996.

Heitzman, Robert E., Jr. "Pensions in a Flat World." *Issue Brief*. Washington, DC: American Academy of Actuaries (October 1995).

Hutchens, Robert M. "Seniority, Wages, and Productivity: A Turbulent Decade." *Journal of Economic Perspectives* 3 (Fall 1989): 49–64.

Munnell, Alicia H. "It's Time to Tax Employee Benefits." In *Proceedings of the Forty-First Annual Meeting of the Industrial Relations Research Association*. Madison, WI: Industrial Relations Research Association, 1989.

Reagan, Patricia B. , and John A. Turner. "Youth, Taxes, and Pension Coverage." Manuscript. Columbus, OH: Ohio State University, Department of Economics, 1994.

Rosen, Sherwin. "Does the Composition of Pay Matter?" In W.T. Alport and S.A. Woodbury, eds., *Employee Benefits, Labor Costs, and Labor Markets in Canada and the U.S.* Kalamazoo, MI: W.E. Upjohn Institute, forthcoming.

Salisbury, Dallas L., Ken McDonnell, and Edina Rheem. "The Changing World of Work and Employee Benefits." *EBRI Issue Brief*, no. 192 (Employee Benefit Research Institute, April 1996).

Snider, Sarah C., and Paul Fronstin. "Sources of Health Insurance and Characteristics of the Uninsured, Analysis of the March 1994 Current Population Survey." *EBRI Issue Brief* no, 158 (Employee Benefit Research Institute, February 1995).

Topel, Robert. "Specific Capital, Mobility, and Wages: Wages Rise with Job Seniority." *Journal of Political Economy* 99 (February 1991): 145–176.

Woodbury, Stephen A., and Douglas R. Bettinger. "The Decline of Fringe-Benefit Coverage in the 1980s." In R.W. Eberts and E.L. Groshen, eds., *Structural Changes in U.S. Labor Markets: Causes and Consequences*. Armonk, NY: M.E. Sharpe, 1991.

Woodbury, Stephen A., and Wei-Jang Huang. *The Tax Treatment of Fringe Benefits*. Kalamazoo, MI: W.E. Upjohn Institute, 1991.

10. Comprehensive Tax Reform and Employee Benefits: The Case of Employment-Based Pensions and Health Insurance

by Daniel I. Halperin and Michael J. Graetz

Introduction

In examining the effects of major tax restructuring on employee benefits, the principal question is about the effects of shifting from an income tax to some form of consumption tax, although many of the same questions would arise if the income tax were "reformed" by eliminating current tax benefits for employment-based benefits pensions and health insurance, or if the income tax were simply repealed.

Massive changes in a nation's tax structure of this kind are substantially more difficult than the introduction of the new tax from the "beginning" for two reasons: the difficulty of transition, including the issue of how to treat existing assets and liabilities under the new system, and the ongoing impact of the change on institutions that have developed, at least in part, in response to an existing tax system. The transition question itself may be critical to both the effect and political viability of the tax revision. For example, if substitution of a consumption tax for the income tax were to ignore the "basis" of existing assets, which reflects the payment of income tax, and impose a consumption tax on the spending of these funds in a manner identical to expenditures of money earned after the effective date of the change (on which income tax would not have been paid), both the gains in economic efficiency from making the change and the burdens of owners of existing capital would be significantly greater. In addition, the tax rate necessary to raise a given amount of revenues from the new tax would be lower than with a rule that exempted consumption from these preexisting sources. Nevertheless, politicians' notions of equity and political pressures do not seem likely to allow this to happen (Pearlman, 1996).

Until very recently, analysts have paid less attention to the more permanent effects of a major change in the nation's tax system. Currently, the income tax provides subsidies or incentives for numerous activities, including home ownership; charitable institutions; life insurance; and a variety of employee benefits, the most important of which are tax exclusions for employment-based retirement income and health insurance. As has been recognized, there are two ways to eliminate such tax expenditures. One is simply to remove all or part of the special treatment. Most proposals to substitute a consumption tax for the income tax contain no incentive for employment-based health insurance, and Rep. Richard Gephardt's (D-MO) income tax reform proposal would also explicitly reduce the special tax benefits for employment-based pension plans.

The other approach is to eliminate the tax. Even a substantial reduction in rates, as, for example, in the Tax Reform Act of 1986, can have a substantial impact on the willingness of an employer to provide retirement protection or health insurance to employees if a significant portion of the work force prefers cash compensation instead (Halperin, 1993.) Since a consumption tax would eliminate any special treatment of particular forms of investment income, it would contain none of the advantages of the current income tax for employment-based qualified pension or profit-sharing plans or for other forms of tax-preferred retirement savings, such as tax-deferred annuities.

This discussion describes the existing system, attempts to make clear how the existing subsidies for employment-based health insurance and pensions would disappear under the comprehensive tax reform proposals, and offers an assessment of the likely consequences. In the process, it identifies some of the key questions that must be answered.

The effects on employment-based benefits is a key issue in the tax reform debate. These benefits are an important and rising share of total compensation in this country. Employment-based pensions and health insurance account for more than 10 percent of total employee compensation in the United States today.

The Existing Subsidies

Health Insurance Benefits

The current income tax allows employers to deduct and employees to exclude from income health insurance provided to employees. Because of a "preemption" provision of the Employee Retirement Income Security Act of 1974 (ERISA), most such health insurance is provided through employers' self-insuring in order to avoid any state pre mium taxes and state regulation of such health benefits. Currently, the combined federal tax rate (including the individual income tax and payroll taxes for Social Security and Medicare) on the median worker is about 30 percent (down from a 1982 high of about 40 percent). State income taxes (with top rates ranging up to 12 percent) also typically exempt employment-based health insurance. Because of the tax advantages, about 65 cents of health insurance is worth as much as a dollar of cash wages for most employees. Employers today provide health insurance to about 60 percent of the American population, although employer health coverage has been declining in recent years, despite the tax advantages (Shactman and Altman, 1995). The current proposals would eliminate the income tax advantages that favor health insurance over cash wages either by taxing employees or disallowing any deduction to employers. The future of the federal payroll and state income tax incentives is not clear.

Retirement Income Benefits

The Internal Revenue Code (IRC) now also provides a tax preference for so-called qualified pension and profit-sharing plans. Both the IRC and ERISA contain mandates for such qualified plans with respect to vesting, limits on the size of contributions or benefits, and the timing and form of distributions and also contain requirements for reporting and disclosure and possible fiduciary liabilities. Under the current income tax, employers deduct contributions to qualified plans but employees are not taxed until distribution. In addition, the earnings of the deferred compensation trust are exempt from income tax. Contributions to qualified plans are also exempt from federal payroll taxes (except for elective contributions) and state income taxes. With cash or nonqualified deferred compensation, the employers' income tax deduction and the employee's income taxation occur at the same time.

There is much confusion and considerable misunderstanding about the value of allowing employers to deduct currently amounts of compensation that will not be taxed to the employees until their retirement. The mismatch alone may not be important. Deferral of tax is only important to an employee who expects his or her marginal rate to be less at the time of distribution, in which case that reduced rate would apply to the compensation instead of the rate in effect when the compensation was earned. On the other hand, if the employee's marginal rate of tax is the same over time, the income tax advantage of qualified plans amounts solely to the tax exemption for the investment income earned by the trust. This can be illustrated by the following simple example:

First, assume the employee receives cash compensation of $100, pays tax at a 40 percent rate, and invests the remaining $60 for three years, at a 10 percent before-tax rate of return. If the investment income is taxable and the tax is paid from the fund, the accumulation at the end of three years would be $71.46, and this is what the employee would have available to spend at that time. On the other hand, if the investment income were not taxable, the fund would grow to $79.86.

Suppose, however, that instead the $100 of compensation is contributed to a qualified plan and earns a 10 percent rate of return. After three years, the plan would be worth $133.10. If the fund is then distributed and the employee remains in the 40 percent bracket, the net after-tax amount available to the employee would be $79.86, just as it would be if compensation were taxed currently but investment income were free of tax.

If the marginal rate is lower at the time of distribution, the qualified plan provides an additional benefit. For example, if the employee were then in a 30 percent bracket, he or she would have $93.17 after tax (which is the same amount the employee would have if cash compensation were taxed at 30 percent and he or she invested $70 at a tax-free 10 percent rate of return).

As the foregoing example makes clear, with the same pre-tax return on investments for both employers and employees, and no change in employees' tax rates, the entire income tax advantage for qualified plans lies in the exemption from income tax of the earnings of the pension plan trust. Nonqualified deferred compensation does not enjoy this benefit, and the only income tax advantage to such plans would be due to a lower tax rate to the employer than to the employee on investment income or to a lower marginal tax rate at retirement.

Non-Tax Reasons for Employment-Based Health Insurance and Pensions

Tax advantages aside, employers might offer health insurance to their employees for several reasons. First, employers might obtain cheaper health insurance for their employees than they could obtain for themselves. Large employers, in particular, offer opportunities for reducing administrative costs, especially marketing costs, of health insurance and also offer opportunities for risk pooling among many people. Employers are also sometimes said to have an interest in a healthy work force that may be promoted by seeing that their employees have health insurance coverage. Such potential non-tax advantages and the need to speculate about alternative health insurance purchasing arrangements make it difficult to predict the effect of a cutback or even elimination of tax advantages for health insurance on the continuing role of employment-based plans, although if the income tax advantage were eliminated without any replacement subsidy, health insurance coverage of workers would surely decline. One recent analysis suggests that the major tax reform alternatives currently being advanced would raise the after-tax cost of employment-based insurance by 21 percent to 29 percent, depending on the proposal, assuming no change in current state income tax and federal payroll tax advantages for health insurance (Gruber and Poterba, 1996). Clearly, this would stimulate some shifts to cash compensation.

Likewise, there are reasons, apart from tax savings, why employers and employees both might want some portion of compensation to be withheld until retirement. Employees may want to be protected against their own failures to save an adequate amount and may want to take advantage of lower administrative costs or better investment opportunities or advice available through the employer. Employers may also provide their employees greater access to reasonably priced annuity contracts, which would be particularly valuable if, in the case of a defined benefit plan, the annuity is based on replacement of a portion of final earnings. The employer, particularly in the case of a defined benefit plan, may hope to retain employees longer in their most productive years and to facilitate departure of older employees when that has become appropriate. Nevertheless, even with the current tax advantages, we have seen a shift away from defined benefit and toward defined contribution plans.

It is unclear to what extent the widespread existence of employment-based retirement plans depends on their special income tax treatment. It may be that many employers view deferred compensation in lieu of cash as essential for business reasons and select qualified plans as the only deferred compensation vehicle that provides both employee security and favorable tax treatment. Under current law, other forms of deferred compensation, so-called nonqualified plans, may face the prospect of unacceptable credit risks, unfavorable tax consequences, or perhaps both.

If a nonqualified plan is unfunded, employee taxation, as well as the employer deduction, is deferred. For employees, this means that as in the case of a qualified plan, compensation is taxed at the marginal rate in effect when benefits are distributed, but, in the case of nonqualified plans, the investment income is taxed to the employer at the employer's tax rate. This will be no less favorable than the treatment of current compensation if the employee's tax rates are as high as the employer's and may be more favorable if the employee expects a decline in marginal rates or if the employer is subject to a lower tax rate on investment income than the employee.[1]

However, the employee must assume the risk of employer bankruptcy or insolvency, as any assets set aside for the payment of nonqualified deferred compensation must be available to all creditors in these circumstances. So-called rabbi trusts, which limit the employer's access to the fund, are often used to minimize the risk of nonpayment, but it cannot be completely eliminated.

Moreover, under Title I of ERISA, only plans that benefit only a select group of management or highly compensated employees are allowed to be unfunded. If the covered group includes employees who do not fit within the so-called top-hat group, the plan must be funded and will be taxed as indicated below.

If the nonqualified plan is funded, the assets will be protected from the reach of other creditors, but at the price of current taxation of the amounts set aside. This in itself will not increase the tax burden, if a decline in the marginal rate is not expected, and the current tax could be met by withholding the amount of tax due from the contributions to the fund. Still, it may be difficult to explain the withholding to employees. More importantly, it is very difficult to avoid double taxation of investment income—once to the trust and secondly to the employee. Therefore, these so-called secular trusts are not widely used. Perhaps, because of these impediments to nonqualified plans, qualified plans, given the tax advantages, are frequently the better choice despite the compliance burdens imposed on the employer under ERISA and the tax code.

The Impact of Tax Reform

Unlike the case of health insurance, where the change in tax consequences is transparent, there is considerable misunderstanding regarding the effects of various tax reform proposals on deferred compensation arrange

[1] In the case of a tax-exempt employer or government, there are restrictions on the amounts that can be set aside without being currently taxed to the employee. This reduces the opportunity to take advantage of a possible future reduction in the applicable marginal rate. However, since the employee is not taxed on investment income until it is distributed, these arrangements can be more favorable than current compensation, although the potential loss of favorable treatment of capital gains must be taken into account. Rep. Gephardt proposes to apply this treatment, which is equivalent to a nondeductible individual retirement account, to all qualified plans.

ments. The effect of a consumption tax generally is to exempt investment income from tax. This occurs directly under traditional forms of sales and value added taxes and under flat tax proposals that tax only wages and pension distributions at the employee level. This means that individuals can take cash compensation, pay taxes on their wages, and earn investment income free of any further tax. As the previous example demonstrates, when investment income is taxed at identical rates, simply deferring the tax on wages until they are distributed during retirement, as the flat tax proposes for qualified plans, creates no advantage except in cases where the employee's tax rate is lower during retirement. Since the investment income on the deferred compensation would not be eligible for special favorable tax treatment relative to other investment income under the flat tax, the potential rate advantage is the only tax benefit. However, under the flat tax, such a rate break seems unlikely, although the workers' levels of income and the level of personal exemptions from tax could create rate differences between years of work and of retirement.

Qualified Plans

The lack of any special tax advantage for the investment earnings of a qualified retirement plan also occurs under the USA tax proposed by Sens. Sam Nunn (D-GA) and Pete Domenici (R-NM). Individuals are allowed a deduction for all amounts saved, which is equivalent to a giant individual retirement account (IRA) or qualified plan treatment for all savings. Thus, as in the case of a qualified plan, the employees would not be taxed on cash compensation that they save directly, and the investment earnings would not be taxed so long as they are reinvested. A tax would occur only at the point of consumption, at the rates prevailing at that time.

If, under the tax reform proposals, all investments would receive favorable treatment equivalent in present value to that now generally reserved for assets held in qualified plans, can we expect employment-based plans to continue at anything like their present level? Qualified plans will certainly be less attractive if the ERISA restrictions remain in place and the tax advantages are eliminated. One question this raises is whether tax reform would (or should) bring with it the end of tax and ERISA restrictions on employment-based retirement plans.

Although the flat tax bill would remove the current limits on contributions and benefits and any requirement for coverage of nonhighly compensated employees, other restrictions are retained. However, pressure to eliminate most other restrictions seems certain to occur. In any event, since these tax reform proposals seem likely to mitigate substantially the unfavorable treatment of funded nonqualified deferred compensation arrangements, employers might shift to nonqualified plans to avoid any restrictions that remain applicable to qualified plans.

Under the Nunn-Domenici USA proposal, the employer level tax is generally equivalent to a value added tax in that compensation, including contributions to deferred compensation plans, would not be deductible. The employee would be taxable in the absence of a qualified plan but current compensation, as well as investment income, would be offset by a deduction for savings. Therefore, there would be no tax burden until consumption occurs with either cash compensation or nonqualified deferred compensation, just as under a qualified plan today.

Nonqualified Plans

The treatment of nonqualified deferred compensation under the flat tax is less clear. The current bill allows deductions only for wages and retirement contributions and suggests that only if compensation is taxable to an employee will it be deductible by an employer. One possibility is that nonqualified deferred compensation would be a nondeductible employee benefit, subject to tax at the employer level by denying any deduction, but not taxable to the employee. Alternatively, this form of compensation would be currently taxable and deductible.[2] In either case, there should be no further tax burden on either investment income or distributions.

Thus, in the case of a qualified plan, there would be one tax, at the time of distribution, while a nonqualified plan contribution would be taxed either to the employer or the employee at the time it is made. As described previously, assuming no change in rates, these results are

[2] Consideration might be given to the continued viability of the deduction regime now applicable to nonqualified deferred compensation. Thus, forfeitable contributions are not taxed until vested, based on the value at that time. The employer deduction is similarly delayed but limited to the amount of the original contribution. In addition, no deduction is ever allowed unless there are individual accounts for each employee. This represents somewhat of a challenge for a defined benefit plan, although it is easily satisfied in the case of a defined contribution arrangement. It is not clear that these asymmetries between deduction and inclusion would continue under a flat tax that has a guiding principle that compensation should be taxed "once" unless it is a means of retaining an incentive for qualified plans.

[3] They may not be equivalent under the payroll tax if contributions to and distributions from qualified plans avoid Social Security tax while contributions to nonqualified plans are taxable. Similar penalties also apply to early distributions under annuity contracts. Of course, as is the case with qualified plans, tax reform would end the advantage of annuity and insurance contracts relative to other savings as well.

equivalent in present value.[3] The only potential tax advantage of a qualified plan as opposed to a funded nonqualified plan or individual savings under the flat tax would be that deferral could result in a lower tax rate. However, given the premise of the flat tax, except to the extent it might be necessary to have a higher rate during the transition period, this would not occur unless the employee would be able to avoid tax on retirement distributions because at that point his or her income was below the taxable threshold. In fact, it seems more likely that revenues would prove inadequate and that higher rates might be required in the future. In sum, the advantage of deferral for qualified plans, if any, would turn on advantages under other taxes, such as payroll taxes or state income taxes, or alternatively, would depend on people believing that deferral provided benefits that it does not. Grounding retirement security policy on the assumption of an illusion— "a deferral mirage" —does not seem wise public policy.

While there is some uncertainty, it seems that employers could establish nonqualified deferred compensation arrangements on a funded basis with tax results equivalent to both qualified plans and individual savings without having to worry about nondiscrimination requirements, restrictions on the timing of distributions, limits on contributions or benefits, or liability to the Pension Benefit Guaranty Corporation. Unless the laws were changed, Title I of ERISA would still impose standards as to eligibility, vesting, funding, and fiduciary responsibility, which might discourage employment-based retirement plans, particularly defined contribution plans where the potential benefits to the employer are less clear. In any event, employer plans that continue to exist probably would be limited to a select group of employees. Thus, whatever pension coverage remained at the employer level would likely be less dispersed across income classes.

Effect on Total Savings

It would seem clear, therefore, that even if one believes that a switch to consumption taxation would increase the overall level of savings, there has to be a concern for the retirement security of low and moderate income employees, who seem likely to continue to be unable or unwilling to save on their own. If for no other reason, savings in the form of qualified retirement accounts may decline because of limitations on distributions from employment-based plans. Such distributions are often prohibited prior to separation from service and in any event are currently discouraged by an excise tax on most distributions prior to age 59½. Obviously, such limitations do not apply to individual savings or nonqualified plans. It would seem difficult to maintain such restrictions on post-tax reform contributions (that would not receive special favorable tax treatment), and there would be great pressure to remove the restrictions from existing arrangements. Such pressure would be difficult to resist. If so, tax reform might have a substantial adverse effect on the total level of savings in addition to shifting the nature of savings from longer to shorter term forms.

The Relationship to Social Security Reform

The potential effect of tax reform on the forms and level of retirement savings, along with the potentially critical effect of the payroll tax treatment of both employment-based health insurance and deferred compensation arrangements, make it extremely important to consider income tax reform and Social Security together. To take but one example, the appropriate level of mandatory retirement savings to be required under any Social Security privatization proposal might vary greatly, depending on the effects of a particular tax reform on employment-based qualified plans.

Likewise, Congress should consider the impact of the likely decline in employment-based health insurance both on the current level of health insurance coverage and on alternative plans for individual provision of coverage, e.g., through medical savings accounts. The tax reform proposals use the increased tax revenues from eliminating the exclusion of health insurance to reduce tax rates, not to fund alternative subsidies for health insurance. It would be no small irony if tax reform were to inspire future support for mandating employer health insurance coverage.

The Relationship to State Tax Reform

It is impossible to predict the effects of federal tax reform on states' fiscal policies, but a number of the proposals eliminate deductions for state taxes as well as the relative advantage for state and local borrowings. At the same time, Congress is asking the states to take greater financial responsibility for such programs as Medicaid and welfare. The effects of federal tax reform on employment-based health insurance and retirement plans might be very different if the states were to take advantage of the elimination of the federal income tax by expanding their own income taxes, or alternatively, were to follow the federal lead and repeal their own income taxes. If the states' actions diverge, the differences in different regions could become very large. To date, little thought has been given to coordination of federal and state tax reform. All we can do here is to identify the issue.

References

Gruber, Jonathan, and James Poterba. “Fundamental Tax Reform and Employer-Provided Health Insurance.” In Henry J. Aaron and William Gale, eds, *Economic Effects of Fundamental Tax Reform*. Washington, DC: The Brookings Insttitution, 1996

Halperin, Daniel I. “Special Tax Treatment for Employer-Based Retirement Programs: Is It “Still” Viable as a Means of Increasing Retirement Income? Should It Continue?” *49 Tax Law Review* , Vol. 49 (1993).

Ronald A. Pearlman, “Transition Issues in Moving to a Consumption Tax: A Tax Lawyer's Perspective.” In Henry A. Aaron and William Gale, eds., *Economic Effects of Fundamental Tax Reform*. Washington, DC: The Brookings Institution, 1996.

Shactman, D., and S. Altman. “A Study of the Decline in Employment-Based Health Insurance.” *Commerce Clearing House Health Law and Policy Reporter* (1995): 5173–5208.

11. The Reality of Tax Reform: What Tax Reform Means For Employment-Based Retirement Plans

by Randolf H. Hardock

Introduction

In response to voter resentment over the burden, inefficiency, complexity, and perceived unfairness of America's tax system, there has been increasing discussion of restructuring, or even repealing, the federal income tax. Most proponents of fundamental tax reform start from the premise that our income tax system is flawed beyond repair—that it is a weight dragging down America's economic growth. The fundamental tax reform proposals currently under consideration focus on reducing the influence of the tax system on free market decisions, and, in some cases, on eliminating the current tax disincentives to savings.

The Internal Revenue Code (IRC) permeates almost every aspect of American economic life. Radical change of the type being considered could have a profound effect on the economy—in some cases for the better, in others for the worse. This discussion reviews, in general terms, what tax reform could mean for employment-based retirement plans.

Put simply, the potential adverse consequences of tax reform on employment-based retirement could be catastrophic. The tax system's encouragement of retirement savings has been instrumental in preparing millions of Americans for retirement. Radical change in the tax rules governing savings generally, and pension savings specifically, could mean the end of the highly successful employment-linked pension system that has been the backbone of American savings over the last few decades.

Since the stakes are high, it is imperative that those who are interested in the retirement security of America's workers participate effectively in the tax reform debate. That will mean not only understanding the substance of the issues and educating decision makers on those issues but also mastering the political rhetoric necessary to make one's voice heard above the din of other interested parties. That is the reality of tax reform.

However, critically participating in the tax reform debate does not necessarily mean opposing tax reform. Along with the risks, tax reform also presents opportunities for expanding retirement security. The current tax system needs to be reformed—simplifying pension rules is a great place to start. But any changes in the tax system, no matter how well intentioned, should not be allowed to undermine the savings and retirement security currently provided by employment-based retirement plans.

Everyone Is Talking Tax Reform

Tax reform is off the back burner. It seems that every few weeks, another elected official announces a plan to restructure our income tax system. As Rep. Richard Armey (R-TX), Majority Leader of the House of Representatives, put it, "These days you can't swing a dead catfish in this town without hitting the author of a flat-tax plan or at least a major tax overhaul."

Rep. Armey has a plan. Rep. Richard Gephardt (D-MO), the Minority Leader of the House, has a plan. So do influential Senators Pete Domenici (R-NM) and Sam Nunn (D-GA). A commission appointed by former senator Robert Dole (R-KS) and House Speaker Newt Gingrich (R-GA) released its report in January 1996. Not to be outdone, Senate Democratic Leader Tom Daschle (D-SD) created a task force that issued a report in February 1996. Now, both the House Ways and Means Committee and Senate Finance Committee have begun to hold hearings on fundamental tax reform.

Some might think that all this activity can be traced to magazine publisher and former presidential candidate Steve Forbes' advertising of his "flat tax" during the 1996 election campaign in Iowa and New Hampshire and his unexpected, albeit temporary, rise in the polls. But Steve Forbes did not start the tax reform debate. He is just one of the latest in a long line of politicians who have tapped into public resentment concerning our tax system.

Americans hate to pay taxes. Most American taxpayers think their own tax burden is too high, and some believe that the federal government wastes much of the money collected. Many Americans are sure that the "other guy isn't paying his fair share." Almost everyone thinks that the IRC is too complex. Finally, there is widespread feeling that the U.S. government is too big and that the Internal Revenue Service (IRS) can be overly aggressive in pursuing its mission.

As long as this public resentment of the tax system remains, we will be debating tax reform. The political process will produce an array of plans that attempt to respond to these public attitudes. These reform plans will differ radically, depending on the sponsors' personal goals (and constituencies). Both Rep. Armey and Rep. Gephardt are saying they want radical reform, but their ideas are very different. For purposes of this discussion, tax reform is defined as any substantial proposal that attempts to tap into the public resentment with the current tax system. In other words, tax reform is anything coupled with the message, "The tax system is broken and we need to fix it."

What is important right now is that the proposals exist at all. Yogi Berra said: "If you come to a fork in the road, take it." He didn't know it at the time, but Mr. Berra was doing a very good job of describing the way the legislative process often works. A review of the history of legislation in the tax area teaches us that, once elected officials start producing plans to address a popular political issue, there is a reasonably good chance that the political process will produce something that purports to solve the problem. Of course, the "solution" may not look like any of the plans that were originally proposed. But, in the end, the legislative process spits something out. That could easily happen with tax reform.

Basic Tax Reform Concepts

Any structural change in a tax system involves decreasing the taxes imposed on certain activities and increasing the taxes imposed on other activities. This is to be distinguished from cutting taxes and either reducing the size of government or increasing the deficit. This latter approach should not properly be part of the debate over tax reform, since a lower overall tax burden could be reflected under any tax system.

The current discussion of tax reform focuses on two main themes for determining how to redistribute the tax burden: (1) shifting away from the "overtaxation" of savings to a consumption tax system and (2) reduction of tax rates through the elimination of special tax rules—base broadening. Specific proposals contain elements of one or both of these themes.

Consumption Tax

A pure consumption tax system would impose taxes only when income is spent on consumer goods and would exempt savings from taxation. Proponents of consumption taxes argue that our current income tax system discourages savings and investment, inhibits the ability of American businesses to compete in a global economy, and wastes valuable resources on compliance. They believe that these factors combine to slow economic growth. Consumption tax proposals generally involve the establishment of a new broad-based tax on consumer spending, repeal of the corporate income tax, and elimination of taxes on savings and investment.

Consumption taxes can be collected in a number of ways: from businesses, from individuals, or in part from each. Some of the general terms important in understanding consumption taxes include the following.

Retail Sales Tax

A retail sales tax is the consumption tax that is easiest to understand, since almost all states currently have such taxes in place. The full tax is collected by the business directly from the final consumer at the cash register or other point of sale. Only the business making the final sale to the consumer is involved in the tax collection process.

Value Added Tax

A value added tax (or VAT) is a tax on the value of all consumed goods and services that is collected in increments as value is added along the production and distribution chain. The VAT system is in effect in most major economies outside the United States (although those economies impose income taxes as well). As with a retail sales tax, a VAT is collected exclusively at the business level. While individuals (from an economic perspective) may bear the burden of the tax, it is not collected directly from them. It is part of the cost of the goods or service purchased, whether as part of the stated price or as an add-on to the stated price.

A pure stand-alone VAT (i.e., a VAT where there is no attempt to integrate with an income tax system) would generally work as follows: A business would be taxed on the difference between its gross sales and its purchased business inputs. Nonbusiness receipts (such as investment income) would not be in the tax base and investment/financing expenses would not be deductible. There would be no deduction for interest or dividends, and wages would not be deductible to the businesses (regardless of whether they are paid in cash or as benefits).

Hybrid VAT/Individual Wage Tax

Retail sales taxes and VATs are regressive; they impose a greater burden on lower income taxpayers than on higher income taxpayers because lower income taxpayers are forced to consume a greater portion of their income. One mechanism for at least partially addressing this regressivity is to combine a VAT with a wage tax, i.e., to adopt a consumption tax that is collected in part from businesses and in part from individuals. Under this hybrid approach, and unlike a pure VAT, the business is allowed to deduct wages. Wages (but not interest or other investment income) are then taxed at the individual level under an income tax. By shifting the tax on wages to the individual, regressivity can be reduced through a variety of mechanisms (e.g., by exempting a certain amount of income from tax). Flat tax proposals currently under discussion impose the income tax on wages at the same rate that is applied in the VAT and eliminate some regressivity by providing a generous personal exemption.

Consumed Income Tax

In general terms, a pure consumed income tax imposes a broad-based individual income tax under which wages and investment income are both taxed, but all amounts added to savings are deducted (approximating an unlimited deductible individual retirement account (IRA)). This is a consumption tax because consumption equals income minus savings. Unlike most other consumption taxes, a consumed income tax is collected from individuals, not businesses. Although collecting taxes from individuals is more complex, an advantage of a consumed income tax is that it can deal with regressivity by adopting a progressive rate structure or a generous personal exemption.

Reducing Income Tax Rates

A second major theme of the tax reform debate is a push to reduce tax rates (marginal, effective, or both), generally through broadening the income tax base or through new taxes on activities that are not currently taxed. Proponents of these types of changes believe that the current income tax system, with its myriad deductions, exclusions, and credits, distorts economic decisions. Some also emphasize that lower marginal income tax rates would increase the incentive to work. This theme is often accompanied by rhetoric that "loopholes" are designed for special interests.

In general terms, the base-broadening exercise can be seen as an extension of the 1986 Tax Reform Act effort. In the 1986 legislation, Congress closed a wide array of "loopholes" (e.g., repealing the investment tax credit, cutting back on accelerated depreciation, repealing the deductions for sales tax and nonmortgage interest, imposing tighter limits on retirement plans and individual retirement arrangements, imposing stringent new limits on tax-exempt financing, and repealing the capital gains deduction) and imposed certain new taxes (individual and corporate alternative minimum taxes). The revenue raised by these changes was used to reduce individual and corporate tax rates.

Significantly, base broadening can be easily combined with certain consumption tax efforts, particularly those involving a wage tax. By broadening the wage tax base, consumption tax advocates are able to achieve a lower tax rate. For example, a flat tax proposal could be adopted, while retaining all of the deductions available to individuals under current law. However, by adding base broadening to a flat tax (e.g., through repeal of the home mortgage interest deduction), a lower (and politically more attractive) flat tax rate can be achieved.

Major Tax Reform Proposals

Earlier, we considered a pure retail sales tax and discussed a pure VAT and a pure consumed income tax. However, tax laws are never pure and rarely simple. With that in mind, we can review some of the major tax reform proposals that are currently under consideration.

The National Retail Sales Tax Act

This act was introduced by Reps. Dan Schaefer (R-CO) and W.J. (Billy) Tauzin (R-LA). A retail sales tax proposal has also been floated by Sen. Richard Lugar (R-IN), and Ways and Means Committee Chairman Bill Archer (R-TX) has hinted that he favors this approach.

The National Retail Sales Tax Act would repeal the individual and corporate income tax, the estate and gift tax, and most existing excise taxes. These taxes would be replaced with a 15 percent national retail sales tax. Income that is saved or otherwise invested, and earnings on these amounts, would not be taxed until consumed. In order to eliminate some of the regressivity inherent in a retail sales tax, every wage earner would receive a refund equal to the sales tax rate times the poverty level. Home mortgage interest would not be taxable. Sales tax due on a sale of a principal residence would be payable in installments over a 30-year period.

Current tax incentives for employment-based retirement plans would become irrelevant. With the elimination of the income tax, all tax rules governing employment-based pensions (including pension nondiscrimination rules) would be repealed, although Employee Retirement

Income Security Act of 1974 (ERISA) rules would continue to apply. Additions to savings (and earnings on such savings), whether or not provided in an employment-based setting, would not be taxed until consumed.

The Freedom and Fairness Restoration Act (Flat Tax)

This act was introduced by Majority Leader Armey and Sen. Richard Shelby (R-AL). Similar flat tax proposals have been floated by Steve Forbes and Sen. Arlen Specter (R-PA).

The flat tax would apply a single tax rate to all taxpayers—both businesses and individuals. The bill would set the flat rate at 20 percent for the first two years and 17 percent thereafter. Businesses would pay the flat tax on sales minus purchased business inputs (including wages). Employment-based health insurance and other fringe benefits would not be deductible to the business. Individuals would pay the tax on wages, with savings and investment income not being taxed. A generous personal allowance (a deduction based on family size) would be provided to help reduce regressivity, but all other itemized deductions would be eliminated.

Employer contributions to qualified retirement plans (and earnings on such amounts) would not be subject to tax at the business level (i.e., as with wages, the employer would get a deduction). However, distributions from these retirement plans would be taxed to the individuals when received. Pension nondiscrimination rules would generally be repealed, although ERISA rules would continue to apply. Salary reduction contributions to sec. 401(k) plans, sec. 403(b) tax-sheltered annuities, and sec. 457 plans would no longer receive any unique income tax advantages. These salary reduction contributions (and all other additions to saving outside of employment-based plans) would not be excluded from income, but earnings on these savings would never be taxed.

Unlimited Savings Allowance Tax (USA)

Introduced by Sens. Domenici and Nunn, the USA tax combines a business level VAT with a modified consumed income tax on individuals. The business level VAT would generally follow a pure VAT model, taxing business receipts minus purchased inputs. Under this approach, wages are not deductible business inputs and are generally included in the business tax base. The individual tax would follow an income tax model. The individual income tax base would include wages, all employment-based employee benefits, and amounts withdrawn from savings. An unlimited deduction for additions to savings would be allowed. Additional deductions would be allowed for personal exemptions, a "family living allowance," home mortgage interest, higher education expenses, and charitable contributions. Certain advantages for interest on state and local government borrowing would also be retained. Progressivity would come from a graduated rate schedule (with rates ranging from 8 percent to 40 percent, when fully phased in), the family living allowance, and an expanded earned income tax credit.

For purposes of the VAT, a business could not deduct contributions for employee compensation, including contributions to employment-based retirement plans. However, employer retirement plan contributions (and earnings on such amounts) would not be included in employee income under the theory that it is as if the employer saved those amounts on behalf of the employee. Retirement plan distributions would be included in the individuals' income. Additions to savings, outside the employment-based system (and earnings on such savings) would not be taxed until consumed.

The 10 Percent Tax

Introduced by Rep. Gephardt, the 10 percent tax eliminates virtually every deduction, credit, and exclusion. Repealed provisions would include the deductions for charitable contributions and state and local income taxes. The child care credit would be eliminated, as would the exclusions from income of interest on state and local government obligations and all employment-based health insurance. The only itemized deduction allowed would be for mortgage interest. Income tax rates would be reduced for most Americans. The rate structure would be progressive, with marginal tax rates ranging from 10 percent to 34 percent. However, most taxpayers would pay tax at the 10 percent rate. For a family of four, higher marginal tax rates would not apply until income exceeded about $60,000. The 10 percent tax does not make major changes in the corporate income tax, although it does include a significant number of proposals that are characterized as the elimination of "corporate welfare," and it redirects the revenue raised into tax cut proposals targeted at small businesses.

The current law exclusion for contributions to employment-based retirement plans would be repealed, i.e., all contributions would be subject to income tax when contributed. Investment income of an employment-based retirement plan would not be subject to taxation until distributed.

Other Tax Reform Proposals

Two other proposals have received considerable press attention lately, although they have not, to date, been introduced as legislation.

The National Commission on Economic Growth and Tax Reform was appointed by former Sen. Dole and Speaker Gingrich, and chaired by Former Secretary of Housing and Urban Development Jack Kemp. In January 1996, the “Kemp Commission” released a report that called for the repeal of the current IRC in its entirety. Although the report does not include a great deal of detail, it calls for a “new simplified tax system” with a single low rate that taxes income only once.

In February 1996, a task force headed by Sen. Jeff Bingaman (D-NM) presented a report to Senate Minority Leader Daschle that contained a number of specific proposals designed to “address wage and income stagnation.” The Bingaman report suggested a variety of fundamental changes in the tax system, including reductions in individual taxes; revision of the corporate income tax through the creation of different tax rates for businesses that provide employees with a certain level of benefits; and the imposition of a securities transfer tax on any transfer of securities within two years of purchase.

Tax Incentives for Savings

There are three basic ways that a tax system can provide advantages to a savings activity:

- It can provide an up-front exclusion or deduction from income taxation (a “front-loaded” tax advantage).
- Taxation of investment income can be deferred until distributed (“inside build-up”).
- Distributions can be exempted from tax when withdrawn (a “back-loaded” tax advantage).

Our current tax system generally provides a front-loaded tax advantage for employment-based retirement savings combined with inside buildup on earnings on these contributions. Distributions are generally taxed when removed from the employment-based plan or other tax-favored retirement vehicle. This approach generally applies to all types of employment-based retirement plans (e.g., plans under sec. 401(a), sec. 401(k) plans, sec. 403(b) annuities, and sec. 457 deferred compensation plans).

In order to understand fully the impact of tax reform proposals on employment-based retirement plans, one must recognize that some of these proposals would provide a back-loaded tax incentive to certain types of savings (i.e., they provide no up-front deduction, but earnings would not be taxed as they accrue or at distribution). Moreover, it is important to understand that even though front-loaded and back-loaded incentives have different impacts on cash flow, they are mathematically equivalent, assuming tax rates stay the same.

These points can be best illustrated through an example. As indicated in table 11.1, an individual putting $2,000 in a front-loaded savings vehicle will, on withdrawal, have the same amount of money that he or she would have had if the money had been put in a back-loaded savings vehicle.

This equivalency will hold under all tax rate, holding period, and investment return assumptions. However, critical to the equivalency of front-loaded and back-loaded savings vehicles is that the tax rate at the time of contribution is the same as at the time of withdrawal. If tax rates are different, the vehicles will not be equivalent.

Table 11.1
Front-Loaded Incentives Are Equivalent to Back-Loaded Incentives

	Front-Loaded	Back-Loaded
Amount Available for Saving	$2,000	$2,000
Tax on Initial Investment[a]	0	560
Contribution Amount	2,000	1,440
Value after Five Years[b]	2,939	2,116
Taxes on Distribution[a]	823	0
Total Distribution	2,116	2,116

Source: Randolf H. Hardock.
[a]Assumes 28 percent tax rate.
[b]Assumes 8 percent rate of return, no immediate tax on inside buildup.

Effect of Tax Reform on Employment-Based Retirement Plans

For employment-based retirement plans, income tax incentives are by no means the only reason an employer might sponsor a plan. These plans provide employers with a number of nontax advantages. For example, delayed vesting can lead to lower employee turnover. Similarly, the availability of a retirement plan can also make it easier for an employer to move less productive workers out of the work force by making retirement a financially viable alternative. Modest payroll tax advantages also accrue to employers maintaining qualified plans (other than salary reduction arrangements). In addition, economies of scale may apply to retirement savings in a group format (e.g., lower administrative costs and better investment opportunities and advice).

Despite these advantages, there can be little dispute that tax incentives have played a critical part in fueling the growth of employment-based plans over the last 50 years. Significantly, our current voluntary pension system is built primarily on tax incentives *for workers*. The employer's income tax treatment is not affected by whether the worker receives compensation in the form of cash or contributions to a retirement plan. It is the worker who receives the tax benefit of an exclusion from income and inside buildup.

Determining the effect of tax reform proposals on any segment of the economy or on any activity involves analysis at many levels. It is not sufficient to look at the black letter tax law treatment of a particular activity (the direct change in tax incentives). Even if the tax treatment of an activity is unchanged, that does not mean that reform will not change the activity. Changes in the tax treatment of competing activities can cause a diversion of resources from the original activity. Similarly, the tax system overall can have a substantial effect on the individuals and entities engaging in the activity and on the economy, both at a national and local level.

Direct Change in Tax Incentives

The simplest way to analyze the impact of various tax reform proposals on employment-based retirement plans is to compare the tax treatment in effect today (front-loaded) with the new proposals' tax treatment of employment-based plans.

Retail Sales Tax Act and USA Tax—Employment-based retirement plans would continue to receive front-loaded tax advantages. Thus, under the simplistic direct analysis, the tax treatment of these plans is unchanged.

Flat Tax—Just as under the Retail Sales Tax Act and the USA tax, the direct tax treatment of employment-based retirement plans (other than salary reduction arrangements) would be unchanged, i.e., those plans would continue to receive front-loaded tax advantages. Salary reduction contributions under sec. 401(k) plans, sec. 457 plans, and sec. 403(b) annuities would no longer receive front-loaded tax treatment but would receive back-loaded treatment.

10 Percent Tax—Employment-based retirement plans would receive neither a front-loaded nor a back-loaded tax incentive. However, tax on inside buildup in employment-based plans would continue to be delayed until distribution. As under current law, earnings on most other savings would be taxed immediately. By eliminating the front-loaded tax advantage, the incentives to maintain an employment-based plan would be substantially reduced, and a decline in coverage and benefits under such plans could be expected.

Relative Value of Tax Benefits

In a tax reformed world, whether workers would want to continue to receive their compensation in the form of employment-based retirement plans (and employers would want to continue to provide compensation in that form) would not be based exclusively on an examination of the direct tax treatment but rather on a comparison of the tax advantages available to the employment-based plan with the tax advantages available to the worker if he or she saves the amount on his or her own. When one examines the major consumption tax proposals in this way, it becomes clear that the implementation of these reform plans would significantly reduce the incentive to maintain employment-based retirement plans.

Retail Sales Tax Act and USA Tax—Both of these proposals effectively level the tax playing field between employment-based retirement savings and savings generally. But savings outside the employment-based system would be unlimited, completely liquid, and would not be subject to any of the rules applicable to employment-based arrangements (e.g., ERISA, the Age Discrimination in Employment Act, the Family and Medical Leave Act of 1993, the 1964 Civil Rights Act, and the Uniformed Services Employment and Reemployment Rights Act of 1994). Since employment-based retirement plans would be treated worse than other savings from both the employer and the employee perspective, one can reasonably expect a substantial curtailment of these plans. Salary reduction arrangements would be particularly hard hit because the employer benefits of these plans (e.g., payroll tax, employee retention advantages) are less substantial and restrictions on employee flexibility (e.g., distribution restrictions) are relatively more stringent. The USA tax would also provide a deduction for payroll taxes that would further erode the relative advantages of employment-based retirement plans.

Flat Tax—Behavioral response to the flat tax proposal is somewhat more complicated, but, on the whole, the proposal would also lead to a reduction in the incentives to maintain employment-based retirement plans. As under the Retail Sales Tax Act and USA tax, salary reduction plans would be substantially cut back. In the absence of the front-loaded incentive, it is reasonable to expect that, under the flat tax, many employment-based 401(k) plans, 403(b) annuities, and 457 plans would be terminated over time.

Moreover, under the flat tax, employers and employees must make the choice between front-loaded tax advantages through employment-based plans and back-loaded tax advantages that are afforded to all other savings. As previously illustrated, front-loaded and back-loaded incentives are equivalent if tax rates stay the same. However, tax rates would not necessarily stay the same, even under a flat tax, in part due to the personal allowance and in part because it is reasonable to assume that the tax system (and the tax rates) will be changed again and again by future Congresses.

If an individual believes his tax rate will be higher in retirement, his economic interest would be not to participate in a front-loaded, employment-based plan. If an individual believes his or her tax rate will be lower in retirement, he or she will want to participate in an employment-based plan. Generally, workers would fit in three categories.

The first group would be those low income workers who have current income below the personal allowance. Since that group is taxed at a 0 percent rate on current income under the flat tax, they can be fairly certain that their tax rate in retirement will be the same or higher. This group would tell the employer they do not want to participate in an employment-based retirement plan. They would rather have additional compensation and retain the option to save or spend it as they desire. Since the flat tax repeals pension nondiscrimination rules, there would be no reason for the employer not to let these low and lower middle income employees out of the plan.

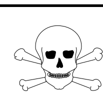
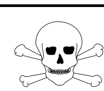
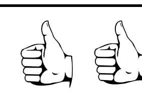
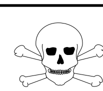
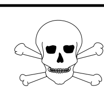
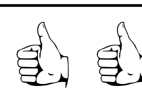
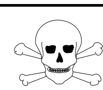
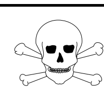
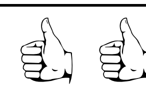
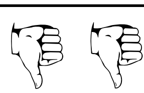
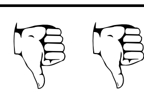
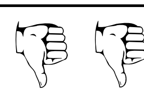
A second group of employees would be middle income workers with current income above the personal allowance but who anticipate that they will have income in retirement below the personal allowance. This group might see continued value in the front-loaded, employment-based plan.

The third group of workers would generally be composed of higher income workers who currently have income above the personal exemption and who expect to have income above the personal exemption in retirement. In theory, this group should be indifferent in choosing between front-loaded and back-loaded incentives. However, in reality this group (and to a lesser extent individuals in the other two groups) can be expected to prefer the back-loaded approach to the front-loaded, employment-based plan. The reason is that most of this group will not believe that the 17 percent rate included in the flat tax bill is sustainable. Many in this group saw the tax rate cuts of the 1986 act disappear over time, and they would almost certainly not want to take the chance that rates will never increase.

Just like the low income group, this higher income group (which will tend to include the decision makers in most businesses) would tell the employer that they do not want contributions made to employment-based plans. They would prefer to take the additional compensation, pay tax at the low 17 percent tax rate now, and decide themselves whether to invest the funds in back-loaded savings vehicles.

10 Percent Tax—By lowering marginal tax rates on many Americans, the 10 percent tax could marginally increase the incentive to save outside the employment-based system. The relative tax advantage of employment-based plans would be reduced because of the lower rates (and the repeal of the up-front deduction previously discussed). However, unlike the consumption tax models, the

Table 11.2
Effect of Tax Reform on Savings Vehicles

Plan	401(a)	401(k)	403(b)	Other Savings
Sales Tax				
USA Tax				
Flat Tax				
10 Percent Tax				

10 percent tax maintains a modest tax incentive for employment-based plans over savings generally, because tax on inside buildup would be deferred until distributed (table 11.2).

Effect on Savings

America's savings problems are well documented. The U.S. personal savings rate has fallen dramatically in recent years. Germans save twice as much as Americans; the Japanese four times more. Americans are not saving enough to meet their own future needs, and America is not saving enough to fuel its own economic growth.

It is generally agreed that increased personal savings would have a large number of beneficial effects, including faster wage growth, lower interest rates, and higher long-term economic growth. Advocates of consumption taxes believe that the elimination of the bias in our tax system against savings would lead to a substantial increase in national savings. In their view, any decline in savings through employment-based plans would be more than offset by increased savings through other vehicles.

Although it is clear that a pure consumption tax would encourage private savings more than a pure income tax, our current system is not a pure income tax. Today's tax laws provide powerful incentives for employees to receive part of their compensation in the form of employment-based retirement plans and other tax-favored vehicles.

These tax incentives have worked. The pension system is the backbone of the nation's current savings effort. According to Stanford economist John Shoven, "The importance of employment-based pensions to total national savings is hard to overstate." His research concludes that "Pensions were and are the mainstay of saving in America."

In analyzing any tax reform proposal, policymakers will be well served in making sure that the long-range savings currently provided through the employment-based retirement system are expanded, not undercut. By changing the relative incentives applicable to the maintenance of employment-based plans and taking the chance that some of these current savings will be shifted into individual savings vehicles, we could see much less of an increase in savings (or even a reduction in savings) for any of a number of reasons.

Psychology of Savings

Americans like to save. They like to save 20 percent off retail. They like to save at outlet stores. Perhaps more than anything else, they like to save on their taxes.

Standard economic analysis says that if you reduce the tax burden on an activity relative to other options, that activity will increase. By increasing the rate of return on savings (through a lower tax rate) and by making consumption more expensive (by taxing it at a higher rate), it is reasonable to assume that savings will increase somewhat. However, the extent of that increase is far from clear.

One reason is that an individual deciding whether or not to save is interested in much more than the simple rate of return. A decision whether to buy a new sports car or put money in a savings account cannot be quantified. The current incentives to save in qualified plans work, at least in part, because individuals believe they are getting a "special deal." Any movement away from the "special" treatment of savings currently provided in the employment-based environment would, at a minimum, offset some of the beneficial effects of reducing the tax burden on savings generally. Conversely, retention of some type of "special," more advantageous, tax treatment for employment-based plans relative to savings generally (even if the tax on savings generally is reduced) could lead to a stronger overall savings incentive.

Locking Money into Retirement Savings

Current savings in employment-based arrangements are, to a significant extent, "locked-in." Generally, preretirement distributions are limited in a wide variety of ways, depending on the type of plan.

Any move away from savings in employment-based plans into individual savings will mean that "saved assets" will becomes more liquid. Looking at the data on the large number of individuals who consume preretirement lump-sum distributions from employment-based retirement plans, it becomes clear that, once savings become available to workers, many are unable to resist the temptation to consume these savings. The same results can be expected if a reformed tax system moves savings from relatively illiquid employment-based vehicles into fully liquid individual savings vehicles.

Moreover, if favorable tax treatment is provided to liquid savings outside of currently tax-favored vehicles (qualified employment-based plans, IRAs, life insurance, and annuities), it is reasonable to assume that there would be considerable, and perhaps irresistible, political pressure to provide similar liquidity to assets currently in tax-favored savings vehicles. The consequences of opening the floodgates to the trillions of dollars in existing tax-favored savings vehicles could be dramatic and should be carefully considered. Clearly, if even a relatively small percentage of these tax-favored assets were withdrawn, there could be a dramatic short-term impact on the economy. More importantly, long-range savings for retirement could be significantly eroded.

Importance of Patient Capital

The “patient capital” generated by employment-based retirement plans has many other benefits for the economy and plan participants. Investment decisions concerning money that one is certain will not be needed in the near future will be different from those that would be made concerning money that might be spent at any time. This might mean the difference between investing in high-yielding, but more volatile, equities instead of a low-yielding, short-term certificate of deposit. In the long-run, equities are better, but if you might want to pull the money out at any time, the volatility risk will be excessive.

Employment-based plans, because they lock in savings (and, in the case of employer-directed investments, because they spread the risk that any particular employee might be eligible for funds immediately), create an environment that allows for long-range patient investment and the higher yields that can be expected to result.

The Employer’s Role in Promoting Savings

An employer that makes a decision to provide a portion of compensation through retirement plan contributions has every incentive to educate workers on the retirement benefits that are being provided. This “free advertising” for savings generally, and retirement savings specifically, would be lost in a move away from employment-based retirement savings. The strength of this employer influence is clearly demonstrated in the recent growth of 401(k) plans. These plans are generally heavily “advertised” by employers and often combined with matching contributions that have successfully encouraged participation by a broad cross-section of employees.

Effectiveness of Payroll Withholding

Any move away from an employment-based system would mean that the regular savings generated through payroll withholding (either directly through salary reduction arrangements or through employer payment of compensation in the form of contributions to qualified plans) would be lost to a significant extent. Although individuals outside the employment relationship would probably fully intend to set aside funds for retirement and other needs, many would procrastinate if it were not for the ease of having the savings done through the employment relationship.

Administrative Savings

Saving through employment-based plans creates significant administrative efficiencies, particularly for large plans. Although these administrative savings are offset somewhat by administrative costs of compliance with the existing regulatory structure governing plans, they can still be significant. Ultimately, these administrative savings can be turned into more savings for retirement.

Individual savings vehicles, on the other hand, will be more expensive to administer than large employment-based plans, and a shift toward savings at the individual level could mean that these additional administrative costs will reduce overall savings.

Effect on Retirement Security

Regardless of the impact of tax reform on savings generally, it could also have very serious adverse consequences for the retirement security of millions of Americans. Net savings could stay the same or even increase, and yet the individuals who are engaged in the saving could change dramatically.

Changes in Who Saves

As savings moves from employment-based vehicles into individual savings vehicles, changes in the amount of savings at different income strata can be expected to occur.

Under most of the consumption tax proposals, it is reasonable to expect that higher income individuals would save somewhat more outside of employment-based plans while lower and middle income individuals would save less due to cutbacks in employment-based savings vehicles. For example, under the flat tax, retirement savings by low and lower middle income workers can be expected to decrease dramatically. These workers are currently earning retirement benefits under employment-based plans for a variety of reasons, including the applicability of nondiscrimination rules. Of course, as employers move away from offering retirement plans under the new tax system, employees would be able to save through new tax-favored individual vehicles. The unfortunate fact is that many will not. In that situation, net national savings might stay the same or even increase, but the retirement security of a particularly vulnerable segment of Americans could be substantially reduced.

Changes in Investment Risk

Movement away from the employment-based retirement system would also dramatically shift investment decisions and investment risk from the employer to the individual. Systemwide, this would mean that individuals would have less available for retirement.

This is easiest to see when looking at defined benefit plans and defined contribution plans that do not provide individual control of account investments. Today, both employers and employees benefit from the higher rate of return that can be generated by having the employer (and professional asset managers) control investment decisions. The worker is protected because the employer bears the investment risk and, in the case of defined benefit plans, the benefits are guaranteed by the Pension Benefit Guaranty Corporation (PBGC). If more and more employers begin to provide compensation in cash, with retirement savings being provided at the individual level, that higher rate of return and the PBGC guarantee will be lost.

Even where there are individually directed investments in defined contribution plans, employee investment risks would be increased. Under our current system, a level of fiduciary responsibility continues to apply in the selection of funds offered to participants. This ensures, among other things, that investment choices presented to plan participants do not include speculative options. It also means that many plan participants will receive at least some level of investment education from the plan sponsor. Any move to individual savings vehicles would mean individuals will have to fend for themselves.

Uneven Distribution of Retirement Savings

The move to allowing individuals greater control over the investment of savings would also mean that some will do better than others—that retirement savings could be expected to be less evenly distributed. As noted, many individuals may make overly conservative investments that lead to diminished retirement security. At the other extreme, individual investment vehicles will leave many workers exposed to high pressure sales tactics and some, perhaps many, will invest in highly speculative ventures that do not pan out. These individuals could end up with no retirement income whatsoever.

What Should Employment-Based Plans Do?

The federal government raises about $700 billion in individual and corporate income taxes each year. Given the continuing federal budget deficit, a reformed tax system would have to raise at least the same amount of revenue. It would be collected differently. It would be collected in different amounts from different people. But the total would be about the same.

Under any tax reform proposal, some people, businesses, and activities would pay more and some would pay less. In other words, there will be winners and losers. The key to successful participation in the tax reform debate will be to try to ensure that you are one of the winners. As the saying goes, "When they start robbing Peter to pay Paul—be Paul."

It is imperative that the impact of any fundamental tax reform proposal be analyzed by looking at the many interlocking changes involved. Although this can be maddeningly complex, it is absolutely necessary because any tax reform proposal will give with one hand and take with the other.

Just as important, these complex interactions will have to be effectively explained to decision makers. Significantly, tax reform proposals to date have been crafted with significant input from economists. Although that type of economic input is critical to any analysis of alternative tax systems, decisions on tax reform will not be made by economists. They will be made by elected officials—politicians who work hard to stay sufficiently in tune with their constituents.

Since very few elected officials are economists, one cannot expect the legislative process to produce a result that conforms to any pure economic theory. To the contrary, history teaches us that the legislative process will produce the proverbial camel. In the end, whether tax reform is enacted and, if so, what provisions are included in a package (the number of humps on the camel), will be driven to a significant extent by the rhetoric that sells with voters.

For employment-based retirement plans, and for the retirement system generally, fundamental tax reform could be catastrophic. The pension community has an obligation to participate in the tax reform debate in order to ensure that any proposal that is ultimately enacted will not damage (and will hopefully expand) the highly successful employment-based retirement system. That will mean not only understanding the substance of the issues and educating decision makers, but also mastering the political rhetoric necessary to convince those decision makers to act.

12. The Impact of Shifting to a Personal Consumption Tax on Pension Plans and Their Beneficiaries

By Jonathan B. Forman

Introduction

What would happen to the pension system if we replaced the current income tax with a consumption tax? With more than $5 trillion in retirement savings at stake and with the baby boom generation rapidly approaching retirement age, the answer to this question is of considerable importance. In particular, policymakers need to be concerned about the impact that shifting to a consumption tax would have on the work, savings, and retirement behavior of workers and on the retirement security of present and future retirees.

Specifically, my focus is on the question of what would happen to the pension system if we replaced the current tax system with a personal consumption tax along the lines of the cash flow tax described in the U.S. Department of the Treasury's *Blueprints for Basic Tax Reform* (Bradford and the U.S. Department of the Treasury Tax Policy Staff, 1984). Basically, under a personal consumption tax, each individual would add up all of his or her wages, dividends, interest, gains, and other income; subtract out the net savings; and pay tax on the balance. I conclude that simply replacing the current income tax system with a personal consumption tax would have an adverse impact on the current pension system and on the adequacy of retirement income for today's low and moderate income workers.

On the other hand, it could make sense to move to a well-designed personal consumption tax if that change were coupled with a mandated pension system or an expanded Social Security program. The personal consumption tax component should have progressive rates, and it should treat gifts and bequests as consumption by both the donor and the donee. The mandated pension component should take the form of individual retirement savings accounts, along the lines of those being considered by the Social Security Advisory Council (Technical Panel, 1995).

The Impact of Shifting to a Personal Consumption Tax

A Simple Personal Consumption Tax

Theoretically, an income tax is imposed on all income, whether that income is saved or consumed. A consumption tax is imposed only on that portion of income that is consumed and not on the portion of income that is saved. However, dissavings (borrowings) must be included in a consumption tax base, while they are not taxed at all under an income tax.

The current federal tax system is really a hybrid income-consumption tax system in which some investments are taxed on the income tax model and others are taxed on the consumption tax model (Aaron et al., 1988; McCaffery, 1992). In general, wages, interest, dividends, and other forms of income are taxed when received, regardless of whether or not they are saved. On the other hand, pension benefits are taxed under the consumption tax model.

For purposes of this discussion, I assume that the current income tax system would be replaced by a *Blueprints*-style cash flow, personal consumption tax. Basically, each individual would total his or her income from wages, dividends, interest, gains, and other sources and subtract out the net savings to get to taxable consumption.

Most investments would be kept in "qualified accounts" that would be handled in much the same way that individual retirement accounts (IRAs) are utilized under current law. A taxpayer would deduct any amount deposited into a qualified account; the earnings on deposits would be tax exempt; and the taxpayer would include the amount of any withdrawals in the tax base. To capture consumption out of borrowed funds, taxpayers would include loan proceeds in the tax base, but they could deduct payments of loan principal and interest.

The "tax prepayment" approach would apply to investments in housing and other consumer durables. Under this approach, investments are not deductible, but the investment proceeds would not be included in the tax base when consumed. For example, the purchase price of an automobile would not be deductible, but the subsequent sales receipts would be excluded from the tax base. Also, if a loan were used to help buy the car, the loan proceeds would be excluded from the tax base, but no deduction would be allowed for repayment of the loan principal and interest.

I also assume that the personal consumption tax would raise as much revenue as the current tax system and that the level of government spending would not change. Finally, I assume that the personal consumption tax would have progressive tax rates that distribute the tax burden across the income distribution pretty much the same way as the current system (Graetz, 1980; Andrews, 1974).

Consequences for the Private Pension System and the Economy

Efficiency, Saving, and Work—Shifting to a consumption tax base would postpone taxes on savings until consumption. Consequently, a consumption tax would be neutral as between current and future consumption. Moreover, a consumption tax would be neutral as between various forms of savings, especially when compared with the current tax system with its range of alternative tax regimes for various investments.

Nevertheless, it is hard to tell what would happen to the overall savings rate. In particular, while high income individuals would tend to save more, low and moderate income individuals who are now "forced" to save in pension plans would tend to save less. Similarly, "target" savers would be able to save less to meet their savings goals. All in all, the increase in nonpension savings that would result from shifting to a consumption tax could easily be offset by a reduction in pension savings.[1]

Shifting to a consumption tax would also have significant distributional impacts. Basically, shifting to a consumption tax would shift the tax burden from savers to spenders. While progressive rates could ensure that a consumption tax was distributionally neutral across income classes, miserly millionaires would pay less tax than profligate paupers. Also, the shift would tend to increase taxes on the young and the elderly while reducing taxes on the middle-aged.

Moreover, because a consumption tax base is, by definition, smaller than an income tax base, higher tax rates would be required under a consumption tax. Consequently, a revenue-neutral shift to a consumption tax would raise tax rates on workers at the same time that it lowered tax rates on savers. And these higher tax rates on earned income would have a significant impact on individual work and retirement decisions.

All in all, it is difficult to tell if shifting to a consumption tax would result in any economic gains. Indeed, much would depend on the number of tax preferences for special interest groups and on the generosity of any transition rules.

Impact on the Pension System—Our $5 trillion employment-based pension system would never have developed without the preferential tax treatment provided by current law. Shifting to a consumption tax would largely eliminate that preference. Instead, individuals would be free to save for retirement through any of a variety of mechanisms. Consequently, the employment-based pension system would surely wither (Heitzman, 1996; Ippolito, 1990; Ippolito, 1994; Salisbury, in this volume; Sawaya, in this volume).

Some employment-based pensions would survive in a consumption tax world but only if they offered advantages to workers and firms (Ippolito, 1990; Halperin and Graetz, this volume). For example, employers might still find it advantageous to use pension and profit-sharing plans to motivate employees toward greater productivity. Moreover, employees might like pension plans because of the lower cost for annuities that comes from pooling workers together. Also, employees might find that pension plan managers could attain higher rates of return on employee retirement savings.

However, over the long run, employment-based pensions would dwindle in number and breadth. After all, in a competitive labor market, employers who force savings on unwilling workers or force high income workers to cross-subsidize savings by low and moderate income workers would lose workers. Moreover, employment-based pensions are heavily regulated and costly to administer (Hay/Huggins, 1990; Hustead, 1996).

Consequently, employers would find it expedient to redesign their compensation systems so that each worker could achieve his or her desired mix of cash compensation and savings. The easy way to achieve this result would be to pay only cash compensation and let each worker save as much (or as little) as he or she likes in the tax-free qualified accounts of his or her choosing. Employers might still offer 401(k) savings plans and might be able to pool willing workers together to buy annuities. But the typical employer would find little reason to provide a traditional defined benefit plan that forced coverage onto the entire work force. All in all, Woodbury estimated that the loss of favorable tax treatment for pensions would reduce pension coverage by

[1] See Eric M. Engen and Willam G. Gale, "Comprehensive Tax Reform and the Private Pension System," in this volume; and Randolf Hardock, "The Reality of Tax Reform: What Tax Reform Means for Employment-Based Retirement Plans," in this volume. Engen and Gale express particular concern about the potential danger of removing the current law penalties on early withdrawal of pension funds. For example, they estimate that, if tax reform caused an additional 1 percent of existing pension balances to be withdrawn and spent each year, personal savings would fall by about $50 billion in 1994 (18 percent of personal savings in 1994).

about 5 percent and reduce total pension contributions by between 40 percent and 50 percent (Woodbury, in this volume).[2]

Congress could probably slow the decline in employment-based pensions by reducing the scope of pension regulation and relaxing the nondiscrimination rules. However, in the long run we should expect a significant decline in employment-based plans and an unequivocal shift from defined benefit plans to defined contribution plans.

But we ought not worry about a decline of employment-based pension plans *per se*. The current preference for employment-based plans has resulted in agency problems that must be policed by extensive government regulation and restrictions that have raised the cost of operating plans (Ippolito, 1990). Moreover, employer plans have not proven themselves to be the best investors of employee retirement savings. In particular, employer plans generally invest too heavily in employer stock, and many employer plans have conservative investment strategies that can easily be topped by Wall Street money managers.

Impact on Pension Beneficiaries: Retirement Security, Retirement Age, and Job Mobility—Perhaps the biggest problem with shifting to a consumption tax is that such a change would have an adverse impact on the retirement security of today's low and moderate income workers (Heitzman, 1996; Salisbury, in this volume). As employment-based pension plans decline, coverage of low and moderate income workers would also decline. Nor would the availability of more tax-free savings vehicles induce these workers to save on their own: the higher rates of return are just not going to have much impact on their savings behavior. Consequently, even if overall savings increased in a consumption tax world, savings by low and moderate income workers would be likely to decrease. Unfortunately, a reduction in savings by low and moderate income workers today could easily cost the government a trillion dollars in the future when these workers demand higher Social Security and Supplemental Security Income benefits.

Shifting to a consumption tax would also have a significant impact on workers' retirement patterns. Obviously, those workers who have not saved enough during their careers would need to work longer. On the other hand, those who save more in response to the reduced taxes on savings would be able to retire earlier.

Also, to the extent that switching to a consumption tax accelerates the shift away from defined benefit plans, we should expect to see many workers stay in the work force longer. First, unlike defined benefit plans, defined contribution plans simply do not subject workers to high "implicit" penalties for continuing to work past normal retirement age (Kotlikoff and Wise, 1988; Ippolito, 1986). Second, while employers with defined benefit plans can use plan assets to subsidize and encourage early retirement, employers with defined contribution plans do not have that option—they basically must pay severance bonuses out of firm income.

The shift to defined contribution plans would also increase job mobility. Because defined benefit plans are inherently back loaded, workers have a real incentive to stay with a firm at least until early retirement age. Also, frequent job changes can dramatically reduce pension benefits under defined benefit plans. On the other hand, workers under defined contribution plans have no similar incentive for staying with a particular employer past vesting (typically within five years).

Public Policy Issues in the Design of a Personal Consumption Tax and Their Employee Benefits Implications

Progressive or Flat Tax Rates

Progressive or flat tax rates can be applied to either an income or a consumption tax base, but rates would have to be somewhat higher on the smaller consumption tax base. In that regard, the *Blueprints*' comprehensive income tax had tax rates for married couples of 8 percent, 25 percent, and 38 percent, and the *Blueprints*' cash flow tax had rates of 10 percent, 26 percent, and 40 percent. Indeed, many analysts would favor moving to a personal consumption tax with progressive rates (Frank and Cook, 1995), and even hard-core advocates of the income tax concede that a well-designed consumption tax with a nice progressive rate structure could be a perfectly acceptable alternative to the current tax system (Munnell, 1992).

Of course, even a "flat tax" with large personal allowances would be at least moderately progressive, and the larger the personal allowances, the more progressive the system would be. But low rates and large personal allowances would work as well in a comprehensive income tax as in a comprehensive consumption tax. Congress can lower rates and/or increase personal allowances any time that it is willing to repeal enough exemptions, deductions, and credits (Gale, 1996).

[2] Similarly, based on their review of the literature, Engen and Gale (ibid.) suggest that switching to a consumption tax would reduce pension coverage by 10 percentage points.

To my mind, the low tax rates and large personal allowances promised in the popular flat tax proposals are more fanfare than anything else. Flat tax proponents want taxpayers to look at the taxable income line on their 1995 federal income tax returns and dream wistfully of lower rates and larger personal allowances.

Of course, some increase in personal allowances might be needed to preserve distributional neutrality if we shifted to a consumption tax. But the large promised personal allowances often disguise the effect of repealing the earned income credit (a refundable credit for low income workers of up to $3,556 in 1996). The earned income credit is not a "normal" feature of either an income tax or a consumption tax, but repealing it has more to do with welfare policy than with tax policy (Forman, 1995a; Yin, 1995).

Health Insurance

Under either a pure income tax or a pure consumption tax, employment-based health insurance would be included in the tax base. But it seems no more likely that Congress would tax employment-based health insurance under a personal consumption tax than under the current tax system (Graetz, 1980). In fact, Congress has been heading in the opposite direction, for example, by adding, and later increasing, the amount of health insurance premiums that can be deducted by self-employed individuals (now up to 30 percent).*

It is true that many of the current tax reform proposals would reach employment-based health insurance, but isn't that just more fanfare—so that taxpayers can dream of applying the promised lower rates to their current-law taxable incomes? Tell them that their taxable incomes would go up by $5,000 per year, and see what they think then.

All in all, the tax treatment of health insurance is a design issue for both an income tax and a consumption tax. If anything, Congress would be less likely to tax employment-based health insurance under a personal consumption tax because it might be viewed as yet another regressive change.

The Tax Treatment of Gifts and Bequests

Another major question in the design of a personal consumption tax involves the tax treatment of gifts and bequests. There is little dispute that, under a personal consumption tax, a donee should be taxed on gifts and inheritances received. As the donee can immediately offset that income by saving, the net effect would be to tax gifts and inheritances when consumed by the donee.

The hard issue is whether to treat gifts and bequests as consumption by the donor, as well. On the one hand, *Blueprints* would allow a deduction for gifts made.[3] On the other hand, a better approach would be to treat gifts as consumption by the donor (Aaron and Galper, 1984; Galvin, 1995; Munnell, 1992). As with the *Blueprints'* approach, the donee would include gifts and inheritances in the tax base. But the donor would not be allowed a deduction for gifts made, and bequests would be taxed when transferred at death. A lifetime exemption of, say, $100,000 per person could be used to permit most families to make a modest level of tax-free transfers (Aaron and Galper, 1984).

There are several advantages to taxing gifts and bequests as consumption by both donors and donees. First, taxing gifts and bequests as consumption by donors could replace current estate and gift taxes. These taxes raise just $15 billion a year (U.S. Congress, 1994)—far less than would be raised by having a personal consumption tax reach the donor's gifts and bequests. Second, treating gifts and bequests as consumption would be a fair way to measure a donor's ability to consume over his or her lifetime. Finally, taxing donors on the value of their gifts and bequests would make a personal consumption tax more progressive, and that might be needed for a consumption tax proposal to get much popular support (Brown, 1980; Munnell, 1992).

The Tax Treatment of Social Security and Welfare Benefits

Another important design issue for a personal consumption tax involves the tax treatment of Social Security and welfare benefits. At the outset, it is worth noting that, under a national sales tax or a value added

*Editor's note: The Health Insurance Portability and Accountability Act of 1996 increased this deduction from 30 percent to 40 percent in taxable years beginning in 1997, 45 percent in 1988 through 2002, 50 percent in 2003, 60 percent in 2004, 70 percent in 2005, and 80 percent in 2006 and thereafter.

[3] In some ways, the *Blueprints* approach is the reverse of the treatment of gifts under the current income tax system. Under current law, a donee is allowed to exclude gifts and bequests from income, but the donor gets no deduction for the gift. Other features of the current system include: a carryover basis for gifts; a fair market value (often stepped-up) basis for inheritances; and estate, gift, and generation-skipping transfer taxes on a small fraction of wealth transfers.

tax, basically every dollar spent would be subject to tax (although transfer payments might be used to offset this burden). However, under a personal consumption tax, Social Security and welfare payments would only be subject to tax if they were expressly required to be included in the recipient's consumption tax base.

Would the designers of a personal consumption tax include Social Security and welfare payments in the consumption tax base? I doubt it. Opponents of consumption taxes already complain about their regressivity. I can't imagine Congress adding fodder for that cannon.

Payroll Taxes

Blueprints did not assume that the current payroll tax system would be replaced under either its consumption or income tax models. On the other hand, at least some of the current tax reform proposals would replace all or part of the payroll tax system, and many would repeal the earned income credit (which currently helps offset the payroll tax liabilities of low income workers). Such changes could have an adverse impact on retirement security and on the overall progressivity of the federal tax system.

Still, I think that Congress should consider integrating the payroll tax into its tax reform efforts (Forman, 1992). First, concerns about fairness may require such consideration. After all, most individuals already pay more in regressive Social Security taxes than they do in income taxes, and most individuals suspect that a consumption tax would also be regressive. Second, the opportunity for tax simplification, especially for low income taxpayers, just should not be missed (Forman, 1996). All in all, an integrated, payroll/personal consumption tax system would be simpler than having two separate taxes, and it could achieve any level of progressivity desired.

The Corporate Tax

Theoretically, there is no need for a corporate tax under either a comprehensive income tax or a comprehensive consumption tax. Under a comprehensive income tax, undistributed corporate profits would be taxed to the shareholders under some form of integration. Under a personal consumption tax, there would simply be no need for a corporate-level tax: shareholders would be taxed when they consumed distributed profits or the proceeds from sales of their stock. Not surprisingly, *Blueprints* recommended repealing the corporate income tax in connection with both its model comprehensive income tax and its model cash flow tax.

However, as a practical matter, it seems unlikely that the corporate tax could ever be repealed (Graetz, 1980). No matter how many Nobel-prize-winning economists lament that "only people pay taxes," workers will never quite accept a tax system that makes them pay more taxes than the companies that they work for. For that matter, even a progressive personal consumption tax would be viewed with suspicion by workers: workers will never understand economic arguments in favor of taxing wages but not profits.

Consequently, it seems likely that a personal consumption tax system would retain a corporate-level tax of some kind. At best, this would simply be some type of withholding tax, with full credit given to shareholders. Unfortunately, Congress seems destined to provide incentives and subsidies for their special corporate friends just as they do under the current system. Nor would value added taxes or national sales taxes be immune from such distortions: how better to reward the "good" corporations than with rebates or credits?

Income Smoothing

Retirees often face lower tax rates than when they were working. Consequently, workers can "smooth out" their incomes by shifting income from their high-tax-rate working years to their low-tax-rate retirement years. This is called "income smoothing," and it is best understood as a windfall that could be eliminated by taxing deferred income at the same marginal tax rates that were paid during the working years (Ippolito, 1990).

Income smoothing would also be a problem for a personal consumption tax with progressive rates or even for a flat-rate personal consumption tax with a large personal allowance. Again, the solution is to design a personal consumption tax system that taxes consumption at the same marginal tax rates that were applicable when the income was earned but saved. However, shifting to a fixed-rate national sales tax or value added tax could largely prevent this income smoothing problem.

A Tax Benefit for Retirement Savings

Shifting to a consumption tax would suggest that Congress was more concerned about the fact that people save than about the reasons that they save. Nevertheless, Congress might want to offer special tax incentives to encourage retirement savings in particular. Certainly, the retirement industry would lobby Congress for special tax credits (or enhanced deductions) that would preserve the relative advantage for retirement savings.

Transitional Issues

The transition from the current tax system to a personal consumption tax could be a difficult one, especially if tax relief were provided for consumption out of savings that have previously been taxed under the current system.[4] Moreover, providing transitional relief for existing savings could reduce the efficiency gains that might otherwise result from moving to a consumption tax. Also, it seems clear that sharp lawyers can find a way to game most types of transitional rules (Ginsburg, 1995; Warren, 1995; Nolan, 1995). Accordingly, I would not be inclined to provide much transitional relief at all.

Shifting to a consumption tax would also raise the question of what to do with the assets that are currently held by pension plans and are subject to early withdrawal penalties (Steuerle, 1996). Repealing the early withdrawal penalties would increase consumption out of these savings and so diminish retirement security for current plan participants (and national savings). On the other hand, retaining the early withdrawal penalties for existing plan assets would result in different treatment for old savings versus new savings and create administrative problems for plans, individuals, and the Internal Revenue Service.

Other Public Policy Issues in a Consumption Tax World

Pension Policy Problems That Remain in a Consumption Tax World

Administrative Costs—If Congress still wanted employment-based pensions in a consumption tax world, it would have to reduce the administrative burdens on such plans. Otherwise, employers would simply terminate plans and let their employees save in tax-free qualified accounts. Thus, shifting to a consumption tax seemingly would necessitate the repeal of much of the Employee Retirement Income Security Act of 1974's regulatory framework (Halperin and Graetz, in this volume). Moreover, shifting to a consumption tax would increase the drive for employers to "outsource" the administration of any remaining employment-based plans.

Revenue-Driven Pension Policy Redux—Shifting to a consumption tax would not miraculously balance the federal budget. Consequently, there is little reason to believe that pensions would be protected from further bouts of revenue-driven pension policy.[5] Willie Sutton robbed banks because that is where the money is, and Congress will continue to tinker with whatever set of tax "principles" govern the more than $5 trillion in retirement savings.

Fortunately, retirement savings would not be quite as obvious a target for revenue raisers under a consumption tax as under the current tax system. That is because shifting to a consumption tax base would result in a serendipitous change in the so-called tax expenditure budget. The current tax expenditure budget estimates the revenue that would be raised if we had a pure income tax system rather than our current "imperfect" hybrid tax system. Not surprisingly, the tax expenditure for retirement savings is one of the largest in the income tax expenditure budget—over $66 billion in 1996 (U.S. Office of Management and Budget, 1996).

However, under a consumption tax base, savings are not supposed to be taxed until consumed. Consequently, the consumption tax expenditure for pensions would be zero (or, to the extent of any "overtaxation" of pensions, negative). Instead, other special tax provisions would move to the forefront as the largest tax expenditures and thus the biggest targets for revenue raisers.

Nevertheless, the Congressional Budget Office and the Joint Tax Committee would continue to dutifully provide estimates of the revenues that could be raised from tinkering with the rules governing retirement savings. It seems likely that Congress would eventually (or immediately) limit employer deductions to employee benefit plans and/or individual deductions to qualified accounts.[6] The forces that have driven past Congresses to adopt the

[4] My own view is that many of those who have savings are elderly taxpayers who have been treated extremely well by the federal government (Forman, 1995b).

[5] In recent years, the federal government's need for revenue has made pension plans an especially attractive target (Utgoff, 1991). Witness such recent changes as the 1993 Tax Reform Act's reduction to $150,000 in the maximum amount of considered compensation, the full funding limit on employer deductions to defined benefit plans, and the incredible delay in passing even the most rudimentary pension simplification legislation.
Editor's Note: In August 1996, Congress passed the Small Business Job Protection Act, which includes the establishment of savings incentive match plans (SIMPLE) for employees of small employers.

[6] As Dallas Salisbury has pointed out, most of the income tax expenditure for pensions is attributable to public plans: only a relatively small portion is attributable to private employment-based plans . As a result, much of the so-called "savings" from curbing pension tax expenditures would be offset by increases in civil service and military pension benefits. Therefore, not much revenue could be raised with a restrictive pension tax policy (Employee Benefit Research Institute, 1994). Nevertheless, I believe that curbing the pension benefits of high income taxpayers would continue to have a great political appeal.

nondiscrimination rules, the $150,000 considered compensation limit, and the $1,000,000 limit on deductible compensation won't suddenly disappear in a consumption tax world. Realistically, just how long could "unlimited" savings accounts last on the Senate floor?

All in all, it seems likely that revenue-driven pension policy will continue to be almost as much of a problem in a personal consumption tax world as it is under the current system. However, it is worth noting that it might be harder for Congress to tinker with a national sales tax or a value added tax: savings simply would not be taxed until spent.

Pension Education—Retirement saving is simply not a priority for most people. For example, only 34 percent of Americans surveyed have actually tried to figure out how much money they need to save for retirement (Public Agenda/Employee Benefit Research Institute, 1994). Consequently, educating people about saving for retirement is already important under the current tax system. In a consumption tax world, education would be even more important because of the decline in pension plan coverage and the shift to individual responsibility for saving and investing.

Preservation of Benefits—Under current law, many plan participants are allowed to borrow from their pension plans before retirement. Also, retirees often exhaust their retirement savings too quickly via lump-sum distributions. But at least there are penalties on early withdrawal of benefits.

One nice thing about a personal consumption tax is that plan loans, like other borrowing, would be included in the consumption tax base. That would be a significant deterrent to borrowing.

On the other hand, participants would no longer have to wait until retirement to get their savings. Also, the shift from defined benefit plans to individual accounts would surely be coupled with an increase in the availability of lump-sum distributions. All in all, preserving benefits for retirees would likely be an even bigger problem in a consumption tax world than under the current system.

Inflation-Adjusted Treasury Bonds—Because firms find it difficult to hedge against inflation, relatively few private pensions or annuities offer benefits with cost-of-living adjustments; yet that is exactly the type of benefit that many retirees want and need. If the U.S. Treasury would issue inflation-adjusted bonds carrying a real interest rate, firms could issue wrap-around annuities that would be protected from erosion by inflation (Technical Panel, 1995; Munnell, 1991; Berry, 1996).

Tax Preferences

Special interest groups would be every bit as interested in obtaining special tax preferences under a personal consumption tax as under the current tax system (McDaniel, 1980; Feld, 1995). In particular, look out for businesses that benefit from current special deductions (like timber and mineral-extraction industries), labor and labor-intensive businesses, homeowners and homebuilders, charities and other nonprofits, and state and local governments.

Ensuring Adequate Retirement Income for Older Citizens

Americans are clearly not saving enough for retirement. In particular, low and moderate income Americans save very little either inside or outside of pension plans. Indeed, less than one-half of low and moderate income workers are covered by private pension plans under current law. Consequently, many analysts have come to believe that "nothing close to universal coverage is achievable unless such coverage is required for all employees" (Halperin, 1993).

Shifting to a consumption tax would only accentuate the problem of ensuring adequate retirement income for low and moderate income workers. Pension plan coverage would decline in a consumption tax world, but low and moderate income workers seem unlikely to increase their own savings in response. With the first baby boomers turning 50 in 1996, Congress needs to be concerned about any change that might jeopardize their retirement security.

Put simply, if Congress decides to shift to a consumption tax, Congress would also need to consider just how to ensure adequate retirement incomes for today's low and moderate income workers. Otherwise, when the baby boom generation reaches retirement, the country could face an even greater retirement security problem than is already anticipated. Specifically, Congress should consider such options as increasing Social Security benefits, increasing Supplemental Security Income (SSI) benefits, and/or mandating employment-based pensions.

In particular, I must express a certain fascination with the prospect of shifting to a consumption-tax-plus-mandated-pension world. For example, Congress might want to replace the current income tax with a personal consumption tax and, simultaneously, enact a mandatory universal pension system (MUPS) that requires employers to contribute, say, 3 percent of wages to individual defined contribution accounts for workers (President's Commission on Pension Policy, 1981).

Actually, it would probably make more sense to have the Social Security Administration (SSA) run the mandated pension program. After all, SSA has a natural monopoly on collection and relatively low administrative costs (Mitchell and Zeldes, 1996).[7] We could simply let the SSA collect another 3 percent in Social Security taxes and deposit these additional payroll taxes into individual retirement savings accounts (IRSAs), along the lines of those being considered by the Social Security Advisory Council (Technical Panel, 1995).

These IRSA accounts would invest in the stock market. Under the so-called individual accounts (IA) approach, these individual accounts would be held by the government, invested in secure equity funds, and annuitized on retirement. Alternatively, under the so-called personal savings accounts (PSA) approach, these individual accounts would be held by financial institutions and directed by individual workers.

Most IRSA proposals would also dedicate a portion of current Social Security tax revenues to these IRSAs. The result would be a two-pillar system that guaranteed each worker a minimum Social Security benefit and provided each worker with an individual defined contribution account invested in the private sector. For example, it could make sense to deposit both the 3 percent in new payroll taxes and, say, 2.4 percent of the current 12.4 percent Social Security payroll taxes into these IRSAs. The result would be a partially privatized system in which 5.4 percent of payroll would be invested in the private sector, while the other 10 percent of payroll would remain in the basic Social Security system and invested in U.S. Treasury bonds.

Of course, there are many who would prefer to simply expand the existing Social Security and SSI programs. Indeed, the Social Security Advisory Council was deeply divided on the question of whether to simply expand the current Social Security program or instead partially privatize it.

All in all, I see the makings of a bipartisan political compromise here. Opponents of mandated pensions might be willing to support a proposal that simultaneously allowed for the partial privatization of Social Security. On the other hand, defenders of the current Social Security system might be willing to support the partial privatization of Social Security if the mandated pension component led to increased retirement benefits for low and moderate income workers. Moreover, current opponents of shifting to a consumption tax might well support a personal consumption tax that is coupled with a mandated pension system.

All in all, a consumption-tax-plus-mandated-pension system could dramatically increase both the savings rate and retirement security for future retirees.

The Tax Expenditure Budget

As already mentioned, shifting to a consumption tax would naturally result in a transformation in the definition of what is "normal" for purposes of estimating tax expenditures: while pension savings show up as tax expenditures in the current income tax expenditure budget, they would not show up in a consumption tax expenditure budget. Nevertheless, it would be useful for the government to continue to produce tax expenditure budgets to highlight the cost of any special tax provisions designed to subsidize agriculture, mineral extraction, historic preservation, and the other special interests that succeed in obtaining consumption tax preferences.

Mandatory Retirement Redux

Rightly or wrongly, defined benefit plans provide employers with a powerful tool that can be used to induce employees to retire. In particular, early retirement subsidies can be, and frequently are, paid out of plan assets. Employers with defined contribution plans cannot easily provide similar benefits: typically, they cannot increase the balance in the individual accounts of retiring employees without violating the nondiscrimination and contribution limits. Additionally, the Age Discrimination in Employment Act (ADEA) makes it virtually impossible to compel employees to retire.

Because shifting to a consumption tax would accelerate the shift from defined benefit plans to defined contribution plans and IRAs, employers could find it increasingly difficult to manage their work force. Some analysts have already complained about the efficiency and social costs of ADEA (Posner, 1995). Although I think that it is unlikely that ADEA would ever be repealed, to the extent that shifting to a consumption tax increased the number of elderly workers, there would surely be many related public policy impacts.

[7] Letting the Social Security Administration handle collections would ensure that contributions were collected on all wages and self-employment income, thus assuring larger retirement incomes for low income, part-time, and short-term workers who might otherwise be excluded by employer coverage, participation, or vesting requirements.

Some Alternatives to a Personal Consumption Tax

Value Added Taxes and National Sales Taxes

Congress could replace the current tax system with a value added tax or with a national sales tax rather than with a personal consumption tax. For the most part, shifting to these alternative types of consumption taxes would have fairly similar impacts on pension plans and their beneficiaries.

Limit the Benefit of Consumption Tax Treatment to Retirement Contributions

If Congress simply wants to increase savings, there may be much better approaches than shifting to a pure consumption tax. For example, it might make more sense simply to allow unlimited retirement savings accounts, as opposed to all types of unlimited savings accounts. This could be achieved by getting rid of the limits on contributions to pension plans and IRAs, the limits on considered compensation, and the funding limits.

I, for one, feel quite differently about providing tax breaks for retirement savings than I do about tax breaks that enable rich people to avoid tax on savings that are intended for bequests to subsequent generations. Moreover, if Congress is concerned about retirement security, it could make sense to provide favorable tax treatment only for those savings that are dedicated for, and preserved until, retirement. The arguments for allowing tax-exempt savings for housing, college, and other preretirement consumption activities just do not seem as compelling.

Just Expand Individual Retirement Accounts

Another alternative to shifting whole-hog to a consumption tax would be simply to expand IRAs, Keoghs, and 401(k)s. One approach would be to eliminate the limit on contributions to IRAs altogether (Ippolito, 1986). Another approach would be to increase the limit on contributions to IRAs to the levels applicable to defined contribution plans (Ippolito 1990; U.S. Congressional Budget Office, 1987). Still another approach would be to allow individuals to save up to 10 percent of their income in IRAs. Indeed, 82 percent of American leaders in government, media, business, academia, and labor favored this approach for increasing retirement savings (Public Agenda/Employee Benefit Research Institute, 1994). Expanding IRAs could also be an effective way to expand coverage, especially for workers in the small business sector of the economy. A step in this direction was taken by the Small Business Job Protection Act of 1996, which allows nonworking spouses to contribute $2,000 (as opposed to $250) to an IRA.

Make Salary Reduction Plans Universal

Another approach would be to require all employers to give their employees the opportunity to execute salary reduction agreements (U.S. Congressional Budget Office, 1987; Lindeman and Ozanne, 1987). In a recent study, 79 percent of the individuals surveyed said that the best way for them to save for retirement is to have money automatically deducted from their paychecks (Public Agenda/Employee Benefit Research Institute, 1994).

Authorize Megaplans

Another alternative would be to allow designated financial institutions to administer defined contribution megaplans for numerous small employers. Employers would contribute to these megaplans; each employee would have his or her own account; and the financial institution would assume all of the reporting, disclosure, and fiduciary responsibilities.

Index the Income Tax for Inflation

Even the staunchest advocates of comprehensive income taxation concede that returns attributable to inflation should not be taxed (Bankman and Griffith, 1992). Consequently, to the extent that savings are currently overtaxed because of inflation, it could make sense to index the income tax for inflation (U.S. Department of Treasury, 1984; Steuerle, 1985; Aaron, 1976).

A partial solution might be to allow taxpayers to set up inflation-adjusted savings accounts that would be taxed under a comprehensive real income tax approach. Basically, these accounts would be indexed for inflation, but investments would be limited to marketable stock and securities that could be marked-to-market. For example, consider what would happen if a taxpayer deposited $10,000 into an inflation-adjusted account, and that money was used to buy General Motors stock. On the last day of the year, the $10,000 investment would be indexed for the year's inflation; the investment's year-end price would be automatically provided by the stock market; and the taxpayer would report a gain or claim a loss deduction for the difference.

Of course, arbitrage would be a problem for such a partially indexed tax system, but it is already a problem for the current hybrid income-consumption tax system. For example, under current law, it is easy for taxpayers to deduct mortgage interest while earning tax-exempt returns on retirement plan assets. All in all, allowing inflation-adjusted savings accounts could help overcome the current income tax system's bias against saving.

MUPS Redux

Even if we don't shift to a consumption tax, there is ample reason to think about mandated pensions. In particular, there is much to be said for the Social Security Advisory Council's IRSA proposals. I believe that Congress should consider enacting legislation that would have SSA collect another 3 percent of payroll in Social Security taxes and deposit these new revenues and, say, 2.4 percent of the current 12.4 percent Social Security payroll taxes into IRSAs that invest in the stock market. Perhaps employers with generous pension plans could be exempted from this additional 3 percent payroll tax.

A less intrusive approach would be simply to increase the withholding rate by 3 percent of wages and allow employees to deposit their large end-of-the-year tax refunds into designated IRAs, IRSAs, or qualified defined contribution plans.

Incremental Changes to the Current Income Tax System

Finally, there are a number of incremental changes that could improve the current system.

Relax the Funding Limits—Most analysts believe that the current funding limits have led to systematic and persistent underfunding of defined benefit plans. Consequently, it would make sense to liberalize or eliminate the restriction on accumulation above 150 percent of termination liability. Also, employers could be allowed to anticipate increases in both the maximum limits and considered compensation. Though not without revenue cost, these changes could help ensure long-term solvency for the pension system (Ippolito, 1990; Gulotta, 1994).

Relax the Nondiscrimination Rules—It could also make sense to relax the nondiscrimination rules (Bankman, 1988; Utgoff, 1991). One approach would be to allow employers that contribute at least 3 percent of each employee's compensation to a qualified plan to provide significantly greater benefits to highly compensated employees.

Preservation of Benefits—To ensure that benefits are preserved until and through retirement, it might make sense to put additional limits on plan loans. It might also make sense to raise the 59½ early retirement age. Finally, it might be appropriate to require annuitization of a greater portion of retirement benefits and to otherwise limit the availability of lump-sum distributions.

Coverage and Portability Issues—Congress could also consider ways to expand coverage and participation in qualified plans. In addition, faster vesting and greater portability could be desirable. Of course, there are limits to what we can expect from a voluntary pension system. Moreover, it might be difficult for Congress to justify using the income tax "stick" just because it found itself unable to enact the consumption tax "carrot."

Fix the Current Tax Expenditure Budget—If we stay with the current hybrid income tax system, we should change the method of estimating tax expenditures associated with retirement plans. Tax expenditure estimates for retirement plans are currently calculated on a cash flow basis.[8] Basically, this method estimates the taxes that "should" be collected on contributions to retirement plans and the income earned on plan assets; it does not measure the value of deferral of income as benefits accrue. Put simply, "No value is placed on the pension promise itself, only on the advance funding of that promise" (Salisbury, 1993).

As a result, the cash flow method overstates the true tax benefits that accrue to the beneficiaries of private pension plans and understates the benefits that accrue to beneficiaries of public pension plans that typically operate on a pay-as-you-go basis (Salisbury, 1993; Korczyck, 1984; Schieber and Goodfellow, 1994). As we can see from years of revenue-driven pension policy, this distortion has had some unfortunate consequences.

A better approach would be to calculate the tax expenditures associated with retirement plans on the "accrual" or "present-value" basis.[9] This method would better reflect the value of the pensions promised by employ-

[8] Salisbury (1993) explains the current cash flow method as follows:

> First, the contributions made to plans and estimated investment earnings are treated as taxable wages. Second, benefits paid by the plans are treated as taxable income. Third, the tax to be paid on benefits is subtracted from the tax that would have been paid on contributions and earnings to get a net tax expenditure estimate.

[9] Munnell (1991) describes the accrual method as follows:

> A better estimate of the annual revenue loss resulting from deferral would be the difference between (1) the present discounted value of the revenue from current taxation of employer contributions and pension fund earnings as they accrue over the employee's working life, and (2) the present discounted value of the taxes collected when the employer's contributions and investment returns are taxable to the employee after retirement.

ers, independent of the level of funding. While switching to the accrual method may not make all that much difference when it comes to estimating the tax expenditure for private pension plans (Munnell, 1991), it would make a tremendous difference in the way we estimate the tax expenditures for governmental plans that are frequently funded on a pay-as-you-go basis.

In particular, the accrual method should be used to estimate the tax expenditure associated with the Social Security system. Basically, the current Social Security tax expenditure estimate captures only the revenue loss resulting from the partial exclusion of Social Security benefits paid in the current year. Consequently, the current method dramatically underestimates the tax expenditure that is implicit in our Social Security system and so distorts public policy choices about the income tax treatment of the various forms of retirement savings. For example, even though the pension system and the Social Security system each pay about $300 billion in benefits a year, the tax expenditure associated with pensions ($66 billion in 1996) is three times as large as the tax expenditure associated with Social Security ($22 billion in 1996) (U.S. Office of Management and Budget, 1996).[10]

Public policy choices often involve comparing apples and oranges, such as pensions and Social Security. But the current tax expenditure budget clearly distorts that comparison. Shifting to accrual method estimates of tax expenditures would help us compare the two systems and perhaps slow the zeal of Congress for revenue-driven private pension policymaking.

Incentives Matter—Another important step would be to begin to evaluate alternative retirement policies on a comprehensive basis. Retirement income has become a four-legged stool—Social Security, pensions, individual savings, and work. We need to be more conscious about how alternative government policies affect individuals' savings, work, and retirement decisions. In particular, we need to learn more about the psychology of savings (Thaler, 1994), and we need to use generational accounting to assess the impact of policy alternatives (Kotlikoff, 1992).

Conclusion

Simply replacing the current tax system with a personal consumption tax would have an adverse impact on pension plans and their beneficiaries. Nevertheless, it could make sense to move to a well-designed personal consumption tax that is coupled with a mandated pension system or an expanded Social Security program.

The personal consumption tax should have progressive rates, and it should tax gifts and bequests as consumption by both donees and donors. The mandated pension should take the form of IRSAs, along the lines of those being considered by the Social Security Advisory Council. One approach would be to have SSA collect another 3 percent in Social Security payroll taxes and deposit these new revenues and, say, 2.4 percent of the current 12.4 percent Social Security payroll taxes into IRSAs that invest in stocks and bonds.

Given the uncertainties of making such major changes and the importance of getting it right, change should proceed incrementally. The transition to a personal

[10] Theoretically, under the accrual approach, the annual revenue loss from the Social Security system should be estimated by determining the excess of (1) the present discounted value of the revenue from current taxation of employer contributions and the earnings implied by the Social Security benefit promise as these accrue over the employee's working life, over (2) the present discounted value of the income taxes paid on Social Security benefits after retirement.

But the current tax expenditure budget makes no effort to estimate the revenue lost from excluding employer Social Security contributions from income. Employer contributions to the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) programs run at roughly $170 billion a year (U.S. Congress, 1994). Consequently, taxing those employer contributions at an average income tax rate of, say, 20 percent would raise about $34 billion a year ($34 billion = .20 x $170 billion).

Nor does the current tax expenditure budget try to estimate the revenue that would be raised on OASI and DI earnings as benefits accrue over the worker's life. One way to get some perspective on the size of this number is to imagine that the Social Security system were fully funded rather than pay-as-you go. In that regard, as of September 30, 1994, there was a 75-year actuarial deficiency of $2.8 trillion in the OASDI program, based on the assumption that future young workers would be covered by the program as they enter the labor force (so-called "open" estimate) (U.S. Department of the Treasury, 1995). (The deficiency jumps to $8.4 trillion if the estimates are instead based on the assumption that no workers would be covered in the future other than those who were aged 15 and over as of September 30, 1994 (so-called "closed" estimate)).

If there really were $2.8 trillion sitting around earning income at a conservative 5 percent rate, it would generate $140 billion in income ($140 billion = .05 x $2.8 trillion). Taxing that income to the individuals accruing benefits at an average tax rate of 20 percent would raise about $28 billion a year ($28 billion = .20 x $140 billion).

Finally, the taxation of Social Security benefits currently raises only about $11.5 billion a year.

All in all, my back of the napkin estimate suggests that the government loses more than $50 billion from not taxing this year's Social Security benefit accruals ($50.5 billion = $34 billion + $28 billion – $11.5 billion), and the present value of the stream of revenue losses of this size could easily be five or ten times as high. In any event, it seems clear that the theoretically correct income tax expenditure for the Social Security system is a lot larger than the $22 billion that shows up in the current tax expenditure budget.

consumption tax could be achieved largely through a gradual increase in allowable contributions to IRAs and other retirement plans, coupled with a gradual easing of the restrictions on these savings (Bradford, 1982). The transition to a mandated pension could be started by making salary reduction agreements universal. This could be followed by having the SSA develop an IRSA system. Later, both payroll taxes and the amounts deposited in these individual accounts could be increased. Eventually, it might even be appropriate to allow these individual accounts to be held by financial institutions and to have their investments directed by individual workers.

Bibliography

Aaron, Henry J., ed. *Inflation and the Income Tax*. Washington, DC: The Brookings Institution, 1976.

Aaron, Henry J., and Harvey Galper. "A Tax on Consumption, Gifts, and Bequests and Other Strategies for Reform." In Joseph A. Pechman, ed., *Options for Tax Reform*. Washington, DC: The Brookings Institution, 1984.

Aaron, Henry J., Harvey Galper, and Joseph A. Pechman, eds*., Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax.* Washington, DC: The Brookings Institution, 1988.

Andrews, William D. "A Consumption-Type or Cash Flow Personal Income Tax." *Harvard Law Review* 87 (April 1974): 1113–1188.

Bankman, Joseph. "Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?" *University of Chicago Law Review* 55 (Summer 1988): 790–835.

Bankman, Joseph, and Thomas Griffith. "Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?" *Tax Law Review* 47 (Winter 1992): 377–406.

Berry, John M. "Coming From Treasury: Bonds Safe From Inflation." Washington Post, 17 May 1996, F1.

Bradford, David F. "The Possibilities for an Expenditure Tax." *National Tax Journal* 35 (September 1982): 243–251.

Bradford, David F., and the U.S. Treasury Tax Policy Staff. *Blueprints for Basic Tax Reform*. Second edition. Arlington, VA: Tax Analysts, 1984.

Brown, E. Cary. "Comments by E. Cary Brown." In Joseph A. Pechman, ed. *What Should Be Taxed: Income or Expenditure?* Washington, DC: The Brookings Institution, 1980.

Engen, Eric M., and William G. Gale. "Comprehensive Tax Reform and the Private Pension System." This volume.

Feld, Alan L. "Living with the Flat Tax." *National Tax Journal* 48 (December 1995): 603–617.

Forman, Jonathan B. "How to Reduce the Compliance Burden of the Earned Income Tax Credit on Low-Income Workers and on the Internal Revenue Service." *Oklahoma Law Review* 48 (Spring 1995a): 63–77.

_________. "Reconsidering the Tax Treatment of the Elderly: It's Time for the Elderly to Pay Their Fair Share." *University of Pittsburgh Law Review* 56 (1995b): 589–626, reprinted in *Tax Notes* 69 (October 23, 1995): 485–500.

________. "Simplification for Low Income Taxpayers: Some Options." *Ohio State Law Journal* 57 (No. 1, 1996): 145–201.

_________. "Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples." *Tax Lawyer* 45 (Summer 1992): 915–969.

Frank, Robert H., and Philip J. Cook. *The Winner-Take-All Society.* New York, NY: Free Press, 1995.

Gale, William G. "The Kemp Commission and the Future of Tax Reform." *Tax Notes* 70 (February 5, 1996): 717–727.

Galvin, Charles O. "A Consumed Income World—The Low Income and Prospects for Simplification—Replies to Professors Fleming and Yin." *Florida Tax Review* 2 (No. 9, 1995): 552–558.

Ginsburg, Martin D. "Life Under a Personal Consumption Tax: Some Thoughts on Working, Saving, and Consuming in Nunn-Domenici's Tax World." *National Tax Journal* 48 (December 1995): 585–602.

Graetz, Michael J. "Expenditure Tax Design." In Joseph A. Pechman, ed., *What Should Be Taxed: Income or Expenditure?* Washington, DC: The Brookings Institution, 1980.

Gulotta, Michael J. "Changing Private Pension Funding Rules and Benefit Security." In *Pension Funding & Taxation: Implications for Tomorrow.* Washington, DC: Employee Benefit Research Institute, 1994.

Halperin, Daniel I. "Special Tax Treatment for Employer-Based Retirement Programs: Is It 'Still' Viable as a Means of Increasing Retirement Income? Should It Continue?" *Tax Law Review* 49 (Fall 1993): 1–51.

Halperin, Daniel I., and Michael J. Graetz. "Comprehensive Tax Reform and Employee Benefits: The Case of Employment-Based Pensions and Health Insurance." This volume.

Hardock, Randolph H. "The Reality of Tax Reform." This volume.

Hay/Huggins. *Pension Plan Cost Study for the Pension Benefit Guaranty Corporation.* Washington, DC: Pension Benefit Guaranty Corporation, 1990.

Heitzman, Robert E. *Pensions Under Tax Reform.* Washington, DC: American Academy of Actuaries, 1996.

Hustead, Edwin C. "Retirement Income Plan Administrative Expenses." *In Living With Defined Contribution Plans*. Pension Research Council Working Paper Series. Philadelphia, PA: Wharton School of the University of Pennsylvania, 1996.

Ippolito, Richard A. *An Economic Appraisal of Pension Tax Policy in the United States.* Homewood, IL: Irwin, 1990.

________. *Pensions, Economics and Public Policy.* Homewood, IL: Dow Jones-Irwin, 1986.

________. "Implementing Basic Tax Changes: Income Versus Consumption Tax Treatment." In *Pension Funding & Taxation: Implications for Tomorrow.* Washington, DC: Employee Benefit Research Institute, 1994.

Korczyck, Sophie M. *Retirement Security and Tax Policy: An EBRI-ERF Policy Study.* Washington, DC: Employee Benefit Research Institute, 1984.

Kotlikoff, Laurence J. "IRAs, Saving, and the Generational Effects of Fiscal Policy." In Marvin H. Kosters, ed., *Personal Saving, Consumption, and Tax Policy.* Washington, DC: American Enterprise Institute, 1992.

Kotlikoff, Laurence J., and David A. Wise. "Pension Backloading, Wage Taxes, and Work Disincentives." In James M. Poterba, ed., *Tax Policy and the Economy: 1988.* Vol. 2. Boston, MA: MIT Press, 1988.

Lindeman, David, and Larry Ozanne. "Effects of Tax Policy on Retirement Saving and Income." *Proceedings of the 80th Annual Conference of the National Tax Association—Tax Institute of America* (1987): 98–105.

McCaffery, Edward J. "Tax Policy Under a Hybrid Income-Consumption Tax." *Texas Law Review* 70 (April 1992): 1145–1218.

McDaniel, Paul R. "Comments by Paul R. McDaniel." In Joseph A. Pechman, ed., *What Should Be Taxed: Income or Expenditure?* Washington, DC: The Brookings Institution, 1980.

Mitchell, Olivia S., and Stephen P. Zeldes. *Social Security Privatization: A Structure for Analysis.* Pension Resource Council Working Paper PRC WP 96-1. Philadelphia, PA: Wharton School of the University of Pennsylvania, 1996.

Munnell, Alicia H. "Current Taxation of Qualified Pension Plans: Has the Time Come?" *New England Economic Review* (March–April 1992): 12–25.

________. "Are Pensions Worth the Cost?" *National Tax Journal* 44 (September 1991): 393–403.

Nolan, John S. "The Merit of an Income Tax Versus a Consumption Tax (Erwin N. Griswold Lecture, January 19, 1996)." *American Journal of Tax Policy* 12 (Fall 1995): 207–219.

Posner, Richard A. *Aging and Old Age.* Chicago, IL: University of Chicago Press, 1995.

President's Commission on Pension Policy. *Coming of Age: Toward a National Retirement Policy.* Washington, DC: Government Printing Office, 1981.

Public Agenda/Employee Benefit Research Institute. *Promises to Keep: How Leaders and the Public Respond to Saving and Retirement.* Washington, DC: Employee Benefit Research Institute, 1994.

Salisbury, Dallas L.. "The Costs and Benefits of Pension Tax Expenditures." In *Pension Funding & Taxation: Implications for Tomorrow.* Washington, DC: Employee Benefit Research Institute, 1994.

________. "Tax Reform and Employee Benefits." This volume.

________. "Pension Tax Expenditures: Are They Worth the Cost?" *EBRI Issue Brief* no. 134 (Employee Benefit Research Institute, February 1993).

Sawaya, Richard N. "Taxes, Pensions & Benefits: A Possible Employer View." This volume.

Schieber, Sylvester J., and Gordon P. Goodfellow. "Fat Cats, Bureaucrats, and Common Workers: Distributing the Pension Tax Preference Pie." In *Pension Funding & Taxation: Implications for Tomorrow.* Washington, DC: Employee Benefit Research Institute, 1994.

Steuerle, Gene. "Tax Reform and Private Pensions." *Tax Notes* 70 (March 18 and 25, 1996): 1693–1694, 1831–1832.

________ (a/k/a C. Eugene Steuerle). *Taxes, Loans, and Inflation: How the Nation's Wealth Becomes Misallocated.* Washington, DC: The Brookings Institution, 1985.

Technical Panel. *Report to the Social Security Advisory Council on Trends and Issues in Retirement Saving.* Washington, DC: Technical Panel, 1995.

Thaler, Richard H. "Psychology and Savings Policies." *American Economic Review* 84 (May 1994): 186–192.

U.S. Congress, Staff of the House Committee on Ways and Means. *Overview of Entitlement Programs: 1994 Green Book: Background Material and Data on Programs Within the Jurisdiction of the Committee on Ways and Means.* 103rd Congress, Second Session. Washington, DC: U.S. Government Printing Office, 1994.

U.S. Congressional Budget Office. *Tax Policy for Pensions and Other Retirement Savings.* Washington, DC: U.S. Government Printing Office, 1987.

U.S. Office of Management and Budget. *Budget of the United States Government for Fiscal Year 1997.* Washington, DC: U.S. Government Printing Office, 1996.

U.S. Department of the Treasury. *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President.* Washington, DC: U.S. Department of the Treasury, 1984.

U.S. Department of the Treasury. Financial Management Services. *Statement of Liabilities and Other Financial Commitments of the United States Government as of Sept. 30, 1994.* Washington, DC: U.S. Department of the Treasury, 1995.

Utgoff, Kathleen P. "Towards a More Rational Pension Tax Policy: Equal Treatment for Small Business." *National Tax Journal* 44 (September 1991): 383–391.

Warren, Alvin C., Jr. "The Proposal for an 'Unlimited Savings Allowance.' " *Tax Notes* 68 (August 28, 1995): 1103–1108.

Woodbury, Stephen A. "Employee Benefits and Tax Reform." This volume.

Yin, George K. "Accommodating the 'Low-Income' in a Cash-Flow or Consumed Income Tax World." *Florida Tax Review* 2 (No. 8, 1995): 445–491.

13. Comprehensive Tax Reform and the Private Pension System

by Eric M. Engen and William G. Gale

Introduction

Although tax policy is a perennial topic, a recent wave of reform proposals has taken a dramatic new turn. Rather than modifying the existing income tax, the new proposals would start over with a whole new tax system. While the reforms are motivated by many concerns, simplifying the tax system and boosting economic growth appear to be the principal goals in many cases.[1]

A large portion of any impact of tax reform on economic growth would occur through raising the level of saving.[2] While they would generally reduce the tax burden on nonpension saving, comprehensive tax reforms would remove many of the tax advantages that pensions currently enjoy relative to nonpension saving. The significance of pensions has increased in recent years as pension plans—broadly defined to include traditional defined benefit and defined contribution plans as well as 401(k)s and individual retirement accounts (IRAs)—have accounted for a very large share and increasing share of American saving and wealth accumulation. Therefore, the impact of tax reform on pensions is central to understanding the eventual impact of reform on economic growth.

This discussion explores several aspects of how fundamental tax reform might affect the pension system. It compares recent trends in pension saving and overall personal saving, discusses the current tax and regulatory treatment of private pensions, and considers how pensions might be treated under alternative tax regimes. It then develops estimates of the possible impact of tax reform on pensions, and—via the impact on pensions—on saving. These calculations are intended to highlight the major channels through which tax policy affects pensions, rather than to provide precise estimates of the impact of tax reform. Finally, the discussion includes a number of caveats, sources of uncertainty, and extensions, followed by a short conclusion.

Pensions and Aggregate Personal Saving

Table 13.1 shows that contributions to pensions have been a sizable and increasing portion of personal saving in recent years. From 1985 to 1992 (the latter being the latest year for which data are available), pension

1 See Gale (1995a) for an overview of the issues.
2 Tax reform could also affect growth by raising labor supply and/or improving the allocation of capital.

Table 13.1
Personal Savings and Pension Contributions

Year	Personal Saving	Pension Contributions: Total	Pension Contributions: 401(k)	Pension Contributions: Non-401(k)	Pension Contributions as a Percentage of Personal Saving: Total	Pension Contributions as a Percentage of Personal Saving: 401(k)	Pension Contributions as a Percentage of Personal Saving: Non-401(k)
1984	235.7	90.6	16.3	74.3	38.4	6.9	31.5
1985	206.2	95.2	24.3	70.9	46.2	11.8	34.4
1986	196.5	91.5	29.2	62.3	46.6	14.9	31.7
1987	168.4	92.1	33.2	58.9	54.7	19.7	35.0
1988	189.1	91.2	39.4	51.8	48.2	20.8	27.4
1989	187.8	97.9	46.1	51.8	52.1	24.5	27.6
1990	208.7	98.8	49.0	49.8	47.3	23.5	23.9
1991	246.4	111.1	51.5	59.6	45.1	20.9	24.2
1992	272.6	128.8	64.3	64.5	47.2	23.6	23.7

Source: NIPA Personal Saving figures from Table B-26, *Economic Report of the President* (1996). Pension contribution figures from Table E14 & E23 of *Private Pension Plan Bulletin, Abstract of 1992 Form 5500 Annual Reports*, no. 5 (Winter 1996).

Note: All dollar figures are in billions of current dollars.

contributions have averaged about 50 percent of personal saving. Growth in aggregate pension contributions since the early 1980s has occurred largely through 401(k) plans.

The figures in table 13.1 understate the role of pensions in personal saving because contributions are only one component of the saving that occurs through the pension system. Total pension saving should include contributions, plus reinvested earnings, less withdrawals.[3] As shown in table 13.2, Sabelhaus (1996) calculates that a measure of total pension saving has represented 70 percent or more of personal saving since the mid-1980s. This includes private and government defined benefit and defined contribution plans, thrift plans, and 401(k) plans. Pensions and other tax-preferred saving—IRAs and accumulations in life insurance saving—can account for over 100 percent of net personal saving in the United States from 1986–1993. Shoven (1991) obtains similar results using a somewhat different approach. Table 13.2 also shows that the share of pensions in total saving has increased substantially over the last three decades.

These findings suggest that the effect on pensions is a major component of any impact of tax reform on saving and growth. Moreover—as a matter of simple arithmetic—even relatively minor percentage reductions in pension saving could substantially offset large percentage increases in other saving.

Current Tax Treatment and Regulation of Pensions

Pensions are currently accorded a tax preference for saving. Employer contributions to qualified plans are tax deductible at the firm level. Employee contributions to 401(k)s are also deductible. Pension balances accrue tax free until they are withdrawn, when they are taxed at ordinary income tax rates.

For example, let r be the pretax interest rate,[4] T the holding period, t_0 the income tax rate at time 0 when a contribution is made, t_1 the income tax rate between time 0 and time T, and t_T the income tax rate at time T. Let S_{EE} be the payroll tax rate paid by employees and S_{ER} be the employers' payroll tax rate. Suppose a worker earns $1+S_{ER}$ dollars. After paying payroll and income taxes, the worker could invest $1-t_0-S_{EE}$ dollars in a conventional saving account. After T years the balance would grow to:

(1) $$B1=(1-t_0-S_{EE})(1+r(1-t_1))^T.$$

Alternatively, the worker could invest the gross earnings in a defined contribution pension.[5] After withdrawing the funds and paying taxes in year T, the remaining balance would be:

(2) $$B2=(1+S_{ER})(1+r)^T(1-t_T).$$

One tax advantage of pensions is the untaxed "inside buildup," the nontaxation of earnings on the pension balance until the balance is withdrawn. This allows the balance to grow at the pretax rate r. In contrast, balances in conventional saving accounts accrue wealth only at the after-tax rate of return. Over time, the difference in compounding translates into large differences in wealth accumulation. A second advantage of pensions can occur when people face lower tax rates in retirement than when working. A third tax advantage is that most pensions (but not

[3] Capital gains are excluded from this measure because they are also excluded from measures of personal saving and from national income.
[4] r should be thought of as the return to capital after corporate taxes but before individual level taxes. Hence, the "pretax" return refers to the return free of individual-level taxes.
[5] The issues for a defined benefit plan are more complicated.

Table 13. 2
Decomposition of U. S. Personal Saving
(Percentage of Net National Product)

	1961–1970	1971–1980	1981–1985	1986–1990	1991–1993
Net Personal Saving	6.0	7.2	8.1	5.8	5.9
Retirement	2.0	3.7	6.7	5.7	5.6
Pensions	2.0	3.7	5.4	4.4	4.2
Individual	na	na	1.3	1.3	1.4
Life Insurance	0.7	0.5	0.3	0.6	0.5
Other	3.3	3.0	1.1	–0.5	–0.2

Source: John Sabelhaus, "Public Policy and Saving Behavior in the U.S. and Canada," Mimeo, 1996.

employee contributions to 401(k) plans) are exempt from payroll taxes.[6]

The annual, current revenue loss associated with the tax treatment of pensions exceeds $50 billion per year, according to recent U.S. budget documents. This figure overstates the long-run revenue costs because funds in pensions will generate future tax revenues when they are cashed in.

Partially because they receive tax preferences under current law, pensions also face a variety of regulations. Nondiscrimination rules attempt to ensure that the tax benefits are "equitably" distributed across workers. Asset management rules require that investments be made solely for the benefit of current and future participants and beneficiaries, consistent with the choices of a prudent investor, diversified, and free of conflicts of interest. The last feature has generated a series of "prohibited transactions" rules that become relevant when there is a potential conflict between a pension trustee and the pension investment.

Defined benefit plans must be insured through the Pension Benefit Guaranty Corporation and face minimum contributions requirements. Government regulations also stipulate vesting rules, maximum contribution limits, payout limits, and other features of pension plans.

Because the rules are complex, ongoing administrative costs for pension plans may be high. The 1980s saw numerous changes in pension regulations. Each change in policy generates additional one-time, transitional costs, which may also be large.[7] While workers and firms may tolerate these costs in the presence of a large tax advantage to pensions, it is unclear the extent to which they would do so if tax reform were to put other saving on more equal footing with pensions.

Treatment of Pensions Under Alternative Tax Systems[8]

Under the retail sales tax, pensions would in effect be treated the way they currently are: contributions would be untaxed, accrual would occur at the pretax rate of interest, and taxes would be owed only when the funds were spent (on retail purchases).[9] Of course, other saving would receive the identical treatment. However, there would still be a tax preference for pensions relative to other saving because pension contributions would remain exempt from payroll taxes.

Under a value added tax, cash wages and pensions are treated equally as components of total compensation. Thus, the pension contribution would be taxed. But pensions would retain tax advantages relative to other saving because pension contributions would likely not be subjected to the payroll tax.

Under the USA tax, all pension contributions and other saving would be front loaded, i.e., deductible, but withdrawals would be taxed. Since the USA tax would offer tax credits for payroll taxes, pensions and other saving would be treated equally.

Under the flat tax, nonpension saving is back loaded—the contribution is not deductible, but the withdrawal is not taxable—and the return is not taxable until withdrawn. Employer contributions to pensions are front loaded. Employee contributions would likely also be front loaded, but as Salisbury notes, the language in recent legislative proposals has been ambiguous. Pensions would retain a preference because the payroll tax would not apply to pension contributions.

Under Rep. Richard Gephardt's (D-MO) proposal to modify the income tax, pension contributions would not be deductible, and pension benefits would be taxable. But pensions would retain a preference because pension plan income would continue to accrue at the pretax rate of return, while the return on conventional saving would be taxed on an annual basis, and pension contributions would likely be exempt from the payroll tax as well.

Effects of Alternative Tax Treatment on Pensions

To investigate the impact of taxes on pensions, we

[6] The advantage to saving via pensions versus other saving vehicles can be quite large. Suppose each of the income tax rates is 20 percent, each payroll tax rate is 7.65 percent, and the interest rate is 10 percent. After 25 years, the after-tax balance stemming from earning $1.0765 in year 0 would be $4.95 (B1) in a conventional saving account and $9.33 (B2) in a pension. This example overstates the net difference because the payroll taxes that were paid when the earnings were placed in a conventional saving account may result in added future Social Security benefits. But even if all payroll taxes (and benefits) are ignored, the assumptions in the example imply that one dollar of gross earnings grows to $5.48 in a conventional saving account over 25 years, compared to $8.67 in a pension.

[7] For one analysis of these issues, see Hay-Huggins (1990).

[8] See Salisbury (1995) for a detailed discussion of how the various tax reform proposals would affect the taxation of pensions and other savings.

[9] Pension withdrawals are currently taxable income regardless of whether they are consumed or saved. But if pension withdrawals are thought to be largely consumed, pensions will be treated basically the same under a retail sales tax as they are currently.

focus on two separate issues: How sensitive are pensions to taxes? How do pensions affect nonpension saving?

Sensitivity of Pension Coverage to Taxes

As noted, pensions receive a tax preference but face formidable regulatory and administrative burdens. If the tax preference were the only reason pensions existed, removing that preference would generate substantial negative effects on pensions, at least over the long run. But firms provide pensions for other reasons as well. A large body literature indicates that pensions can be an effective tool to create incentives in hiring or attracting workers and in encouraging workers to retire at the appropriate times. Firms may feel a sense of paternalism on behalf of their workers. There are cost savings to administering pensions in a group rather than on a one-by-one basis. Workers may demand pensions for reasons other than the tax break. Therefore, the empirical sensitivity of pension coverage to taxes is an open question.

Historically, the pension system grew rapidly in the period after the tax preference for pensions was established, and marginal income tax rates rose in the 1950s and 1960s (see discussion in Bernheim (1996)).

Over the 1980s, pension coverage rates and tax rates fell. At first glance, these figures seem to support the finding that higher tax rates raise pension coverage. However, tax rates fell most at the high end of the income distribution while pension coverage fell least at the high end. Tax rates fell least at the low end of the income distribution, where pension coverage fell most. Moreover, controlling for income, pension coverage rates *rose* for female workers, even though women were obviously subject to the same tax changes as men. Generally, changes in pension coverage rates in the 1980s mirrored changes in relative wages in the 1980s. Males, and in particular less educated males, fared poorly, while women's absolute and relative wages and coverage rose. For these reasons, some recent studies have generally discounted the relation between tax rates and pension coverage (Bloom and Freeman, 1992).

Reagan and Turner (1995) reexamine these relationships using data from the 1979, 1988, and 1993 Current Population Survey (CPS) pension supplements. They carefully disentangle tax and income effects and estimate that a 1 percentage point rise in tax rates raises pension coverage by 0.4 percentage points for men. The estimated effects for women are smaller and not always positive.

Gentry and Peress (1994) examine regional variation in the percentage of workers offered different employee benefits as a function of tax rates and other variables. Their main result for our purposes is that a one percentage point increase in the tax rate raises the proportion of workers offered pension plans by 0.89 percentage points.

Effects of Pensions on Saving

A substantial literature has developed around the question of how pensions affect saving. In the simplest life-cycle models, workers save only for retirement. Increases in pension wealth are offset completely by reductions in other wealth, because pensions and other wealth are perfect substitutes. However, a number of issues complicate the analysis. First, unlike conventional taxable assets, pensions are typically illiquid, tax-deferred annuities. Second, people save for reasons other than retirement. Third, the pension literature has noted psychological reasons why pensions may not be good substitutes for other forms of saving. Given all of these theoretical factors, the range of possible outcomes is very wide: pensions can have any effect from reducing nonpension wealth by more than pension wealth (an offset of more than 100 percent) to raising nonpension wealth (an offset of less than zero).

Most empirical studies of pensions suggest offsets of 20 percent or less, and almost one-half suggest either no offset at all or a positive effect of pensions on other wealth. Taken at face value, then, the literature shows little offset between pensions and other wealth. However, recent work by Gale (1995b) has shown that previous empirical work contains a series of econometric biases, each of which biases the results toward finding less offset than truly exists. Some of the biases can even generate an estimated positive effect of pensions on other saving, even when the true relation is fully offset. Gale suggests methods for correcting for most of the biases. After correcting for the biases, his estimates suggest that between 20 percent and 60 percent of pension contributions are net additions to saving.[10]

As noted, much of the growth of pensions since the early 1980s has occurred through 401(k) plans. Other research has examined the impact of these plans on saving, with mixed results.[11]

Illustrative Calculations

These results, combined with the magnitude of

[10] The results vary across estimation techniques. The estimates reported above may still overstate the impact of pensions on saving because Gale (1995b) does not correct for all of the biases.

[11] See Engen, Gale and Scholz (1996) and Poterba, Venti, and Wise (1996) for reviews of the literature that reach differing conclusions about the impact of 401(k)s on saving.

Table 13.3

EFFECTS OF TAX REFORM ON PENSION COVERAGE AND PENSION-INDUCED CHANGES IN TOTAL SAVING: EXPLORATORY CALCULATIONS[a]

(Assumes 50% of initial saving occurs through pensions)

Pensions/Total Saving (%)	50	50	50	50	50	50	50	50	50	50	50	50
Initial Pension Coverage Rate (%)	50	50	50	50	50	50	50	50	50	50	50	50
Percentage of Pension Saving That Is a Net Addition to Saving	20	20	20	20	50	50	50	50	80	80	80	80
Change in Tax on Nonpension Saving (percentage points)	20	10	20	10	20	10	20	10	20	10	20	10
Change in Coverage Rate Due to .01 Change in Taxes (percentage points)	0.5	0.5	0.25	0.25	0.5	0.5	0.25	0.25	0.5	0.5	0.25	0.25
Results												
Change in Pension Coverage Rate (percentage points)	–10	–5	–5	–2.5	–10	–5	–5	–2.5	–10	–5	–5	–2.5
Change in Total Saving Due to Change in Pensions (percentage)	–2	–1	–1	–0.5	–5	–2.5	–2.5	–1.25	–8	–4	–4	–2

Source: Authors' calculations.
[a]Initial pension coverage rate is assumed to be 50 percent.

pension saving relative to overall saving, can be used to develop quantitative estimates of the impact of tax reforms on pensions and via pensions on saving. Before proceeding, it is worth noting that any calculation in this regard should be accompanied by strong caveats, as discussed further in the next section.

The fifth column of table 13.3 works through the following estimate. Suppose that pension contributions account for one-half of saving, that moving to a consumption tax reduces the tax on saving by 20 percentage points, that a 1 percentage point rise in the tax rate raises pension coverage rates by 0.5 percentage points (close to the Reagan and Turner estimates), that 50 percent of pension contributions are new saving, the initial pension coverage rate is 50 percent, and the initial saving level is 100 units (with 50 units in pensions and 50 units in other saving).

Then switching to a consumption tax would reduce pension coverage by 10 percentage points (20*0.5). This is a 1/5 fall in pension coverage and, assuming all pensions are the same size, it would reduce pension saving by 1/5 or by 10 units. Since one-half of this is assumed to be reshuffled saving, nonpension saving would rise by 5 units. Hence, the net effect of tax reform on saving via its effects on pensions would be to reduce overall saving by 5 units (10 units fewer in pension contributions, 5 more in nonpension saving)—or 5 percent.

The remainder of table 13.3 provides alternative estimates under the assumption that one-half of current saving occurs through the pension system. Table 13.4 examines the same scenarios assuming that 70 percent of current net saving occurs through pensions. Table 13.5 assumes that 100 percent of net saving occurs through pensions.

The figures in table 13.3, table 13.4, and table 13.5 reflect a wide range of outcomes, which in turn reflect underlying uncertainty about key parameter values. Nonetheless, two conclusions seem merited. First, the pension system could face nontrivial shrinkage under a wide variety of plausible assumptions. The loss in aggregate saving caused by the impact of tax reform on the pension system rises with the proportion of initial saving that is accounted for by pensions, the sensitivity of pension coverage to tax rates, the assumed change in the effective tax rate on pensions relative to other forms of saving, and the proportion of existing pension saving that represents a net addition to saving. Second, fears that tax reform will largely eliminate the pension system cannot be supported using the parameter estimates in the literature. Under no set of estimates does the pension system experience more than a 10 percentage point drop in coverage rates.

Effects of Tax Reform on Nonpension Saving

Several authors have simulated the impact of moving from an income tax to a pure consumption tax. A number of studies have obtained estimated increases in the

Table 13.4

EFFECTS OF TAX REFORM ON PENSION COVERAGE AND PENSION–INDUCED CHANGES IN TOTAL SAVING: EXPLORATORY CALCULATIONS[a]

(Assumes 70% of initial saving occurs through pensions)

Pensions/Total Saving (%)	70	70	70	70	70	70	70	70	70	70	70	70
Initial Pension Coverage Rate (%)	50	50	50	50	50	50	50	50	50	50	50	50
Percent of Pension Saving That Is a Net Addition to Saving	20	20	20	20	50	50	50	50	80	80	80	80
Change in Tax on Nonpension Saving (percentage points)	20	10	20	10	20	10	20	10	20	10	20	10
Change in Coverage Rate Due to .01 Change in Taxes (percentage points)	0.5	0.5	0.25	0.25	0.5	0.5	0.25	0.25	0.5	0.5	0.25	0.25
Results												
Change in Pension Coverage Rate (percentage points)	–10	–5	–5	–2.5	–10	–5	–5	–2.5	–10	–5	–5	–2.5
Change in Total Saving Due to Change in Pensions (percentage)	–2.8	–1.4	–1.4	–0.7	–7	–3.5	–3.5	–1.75	–11.2	–5.6	–5.6	–2.8

Source: Authors' calculations.

[a]Initial pension coverage rate is assumed to be 50 percent.

Table 13.5

EFFECTS OF TAX REFORM ON PENSION COVERAGE AND PENSION–INDUCED CHANGES IN TOTAL SAVING: EXPLORATORY CALCULATIONS[a]

(Assumes 100% of initial saving occurs through pensions)

Pensions/Total Saving (%)	100	100	100	100	100	100	100	100	100	100	100	100
Initial Pension Coverage Rate (%)	50	50	50	50	50	50	50	50	50	50	50	50
Percentage of Pension Saving That Is a Net Addition to Saving	20	20	20	20	50	50	50	50	80	80	80	80
Change in Tax on Nonpension Saving (percentage points)	20	10	20	10	20	10	20	10	20	10	20	10
Change in Coverage Rate Due to .01 Change in Taxes (percentage points)	0.5	0.5	0.25	0.25	0.5	0.5	0.25	0.25	0.5	0.5	0.25	0.25
Results												
Change in Pension Coverage Rate (percentage points)	–10	–5	–5	–2.5	–10	–5	–5	–2.5	–10	–5	–5	–2.5
Change in Total Saving Due to Change in Pensions (percentage)	–4	–2	–2	–1	–10	–5	–5	–2.5	–16	–8	–8	–4

Source: Authors' calculations.

[a]Initial pension coverage rate is assumed to be 50 percent.

long-run capital stock of 10 percent to 25 percent.[12] Estimates of the impact on long-run saving vary widely due to the characteristics of the model. Studies that include more realistic features of the economy—for example, precautionary saving due to uncertain income; adjustment costs in investment—tend to produce smaller effects. However, these studies by and large ignore the fact that pension saving is a major component of net saving in the United States.

The only tax reform simulation to explicitly address

[12] For example, see Summers (1981), Auerbach, Kotlikoff, and Skinner (1983), Auerbach and Kotlikoff (1987), Gravelle (1991), Engen (1994), Randolph and Rogers (1995), Auerbach (1996), and Engen and Gale (1996).

the presence of tax-based saving incentives in the existing system is presented in Engen and Gale (1996). Holding pension saving constant, we find that moving to a pure consumption tax from a hybrid income tax where 50 percent of saving is in tax-preferred form generates increases in the saving rate of 1.4 percentage points in the first two years and by about 0.5 percentage points in the long run; the ratio of the capital stock to income rises by 14 percent. If transitional relief for consumption out of preexisting taxable assets is provided, these figures fall to 0.8 percentage points, 0.4 percentage points, and 6 percent, respectively.

Thus, a third conclusion also comes out of table 13.3, table 13.4, and table 13.5: the reduction in saving due to changes in pensions could substantially or completely offset any induced increase in nonpension saving.

Discussion

Several aspects of the results in table 13.3, table 13.4, and table 13.5 merit further discussion. First, the time frame of the analysis is unclear. The empirical studies of the sensitivity of pensions to taxes previously noted presumably represent short- or medium-run effects, since policy has changed so rapidly in recent years. But the calculations assume that a percentage drop in pension coverage generates an equal percentage drop in pension saving. This may only be valid in the long run, because pension saving includes not just the contribution but also the accumulated earnings (less withdrawals). In any case, it would not be surprising if the long-term effect of tax reform on pensions were larger than the short-term effect. For example, the long-term effects of the Employee Retirement Income Security Act of 1974 on the composition of pension plans may have been much larger than any short-term effect, because such an effect would have worked largely through the creation (or lack thereof) of new defined benefit plans.

Second, the models and estimates require some "out of sample" predictions. For example, the sensitivity of pension coverage rates to tax rates was estimated in the studies previously cited using a relatively narrow band of tax rates. None of the studies examined regimes in which the effective tax rate on nonpension saving was zero. This inherently increases the uncertainty of the estimates.

Third, the fate of the pension system will also depend on how pension regulations change with tax reform. The current tax treatment of pensions represents a deviation from a pure income tax base and so is considered a tax break in the current system. This in turn is at least part of the justification for nondiscrimination rules and other regulations. However, under a consumption tax, the current tax treatment of pensions is no longer a deviation—it is the standard treatment for all saving. In such an environment, the justification for nondiscrimination rules is more limited. This suggests a motivation to loosen or eliminate the nondiscrimination rules under fundamental tax reform. Such a change would likely have important effects on pensions. It would make it less expensive for firms to establish, maintain, and administer pensions. On the other hand, a substantial proportion of pension participants may be carved out and may not raise their other saving to account for the reduction in pension saving. That is, nondiscrimination rules may have the effect of increasing the saving of people who would otherwise prefer not to save and/or could be reducing the pension saving and overall saving of those who would like to save large amounts. Moreover, if firms currently provide matching contributions in order to meet nondiscrimination tests, removal of such tests could reduce employer match rates, which could further reduce employee contribution rates. However, little is known about the effects of nondiscrimination rules.[13]

Fourth, a related issue is the existence of penalties or prohibitions against early withdrawal of pension funds. Under an income tax, these are intended to ensure that the tax break for pensions is only given for retirement saving. Under a consumption tax, the current treatment of pensions would not constitute a tax break, so the income tax justification for such restrictions would have to be rethought. If the withdrawal restrictions were retained—perhaps because, as noted, pensions would continue to retain tax preferences in a number of cases—pensions would become less attractive relative to other forms of saving. If the restrictions are removed, there might be something of a consumption boom as people withdrew some of their funds before retirement. It bears noting that because pension balances are so large, even a small propensity to consume early out of existing balances could have an impact on savings. For example, pension reserves in defined contribution plans exceed $1 trillion. Some of these funds will be withdrawn every year in order to pay ongoing retirement benefits. If tax reform caused as little as an additional 4 percent of those funds to be cashed in per year for several years (and the funds were spent on consumption goods), personal savings would fall by at least $40 billion, or about 14 percent of personal saving in 1994. We are not presenting withdrawals of 4 percent as the likely effect, just

[13] See Garrett (1995), however, for a recent study of the impact of nondiscrimination rules.

noting that a response of this size can be large relative to other saving responses to tax reform.

Fifth, as noted in equation (2), pension earnings are related to the pretax rate of return. Thus, tax reform could affect the desirability of pensions through interest rate effects. If tax reform were to reduce market interest rates, this would raise the required contributions of defined benefit plans to reach their funding targets. Combined with the loss of a tax preference for pensions, this would place additional pressure on defined benefit plans. The impact of reform on interest rates is uncertain, though.[14]

Conclusion

One of the major goals of tax reform is to raise economic growth and future living standards. To a large extent, these effects hinge on the saving response to tax policy changes. Pensions are a major component of overall saving, and tax reform may adversely affect the pension system. Therefore, understanding the impact of tax reform on pensions is crucial to understanding the impact on economic growth. We have explored these impacts, with several main conclusions: The pension system could face nontrivial shrinkage under a wide variety of plausible assumptions; fears that tax reform will largely eliminate the pension system cannot be supported using the parameter estimates in the literature; the reduction in saving due to changes in pensions could substantially or completely offset an increase in nonpension saving; and all of these estimates are to some extent shrouded in uncertainty.

Bibliography

Auerbach, Alan J. "Tax Reform, Capital Allocation, Efficiency and Growth." In Henry G. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform.* Washington, DC: The Brookings Institution, 1996.

Auerbach, Alan J., and Laurence J. Kotlikoff. *Dynamic Fiscal Policy*. New York, NY: Cambridge University Press, 1987.

Auerbach, Alan J., Laurence J. Kotlikoff, and Jonathan Skinner. "The Efficiency Gains from Dynamic Tax Reform." *International Economic Review* Vol. 24, no. 1 (1983): 81–100.

Bernheim, B. Douglas. "Rethinking Saving Incentives." Prepared for a conference, Fiscal Policy: Lessons from Economic Research, sponsored by the Burch Center for Tax Policy and Public Finance at the University of California at Berkeley, February 2–3, 1996 (revised, March 1996).

Bloom, David E., and Richard B. Freeman. "The Fall in Private Pension Coverage in the United States." *American Economic Review* (May 1992): 539–545.

Board of Governors of the Federal Reserve System. *Balance Sheets for the U.S. Economy 1945–1994.* Washington, DC: The Federal Reserve System, 1995.

Engen, Eric M. "Precautionary Saving and the Structure of Taxation." Mimeo. Federal Reserve Board, 1994.

Engen, Eric M., and William G. Gale. "The Effects of Fundamental Tax Reform on Saving." In Henry J. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform.* Washington, DC: The Brookings Institution, 1996.

Engen, Eric M., William G. Gale, and John Karl Scholz. "The Illusory Effects of Saving Incentives on Saving." *Journal of Economic Perspectives* (Fall 1996).

Feldstein, Martin. "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving." *Quarterly Journal of Economics* (May 1995): 475–494.

Gale, William G. "Building a Better Tax System: Can a Consumption Tax Deliver the Goods?" *The Brookings Review* (Fall 1995a): 18–23.

Gale, William G. "The Effects of Pensions on Wealth: A Re-Evaluation of Theory and Evidence." Mimeo (June 1995b).

Garrett, Daniel M. "The Effects of Nondiscrimination Rules on 401(k) Contributions." Mimeo. 1995.

Gentry, William M., and Eric Peress. "Taxes and Fringe Benefits Offered by Employers." NBER Working Paper no. 4764. Cambridge, MA: National Bureau of Economic Research, 1994.

Gravelle, Jane. "Income, Consumption, and Wage Taxation in a Life-Cycle Model: Separating Efficiency from Redistribution." *American Economic Review* (September 1991): 985–95.

Hay/Huggins Company, Inc. *Pension Plan Expense Study for the Pension Benefit Guaranty Corporation*. September 1990.

Poterba, James M., Steven F. Venti, and David A. Wise. "Personal Retirement Saving Programs and Asset Accumulation: Reconciling the Evidence." NBER Working Paper no. 5599. Cambridge, MA: National Bureau of Economic Research, 1996.

Randolph, William C., and Diane Lim Rogers. "The Implications for Tax Policy of Uncertainty About Labor Supply

[14] See Feldstein (1995) and Auerbach (1996).

and Savings Responses." *National Tax Journal* (September 1995): 429–446.

Reagan, Patricia B., and John A. Turner. "Youth, Taxes and Pension Coverage." Mimeo. 1995.

Sabelhaus, John. "Public Policy and Saving Behavior in the U.S. and Canada." Mimeo. 1996.

Salisbury, Dallas L. "Tax Reform and Employee Benefits." This volume.

Shoven, John B. *Return On Investment: Pensions Are How America Saves*. Washington, DC: Association of Private Pension and Welfare Plans (1991).

Summers, Lawrence H. "Capital Taxation and Accumulation in a Life Cycle Growth Model." *American Economic Review* (September 1981): 533–544.

U. S. Department of Labor. Pension and Welfare Benefits Administration. *Private Pension Plan Bulletin, Abstract of 1992 Form 5500 Annual Reports, Number 5* (Winter 1996).

This research was supported by a grant from the National Institute on Aging. The opinions in this discussion paper represent those of the authors; they should not be ascribed to the officers, employees, or staff of the Federal Reserve Board or the Brookings Institution.

14. The Impact of Fundamental Tax Reform on Employment-Based Health Insurance[1]

by Jonathan Gruber and James Poterba

Introduction

Current tax reform proposals call for expanding or redefining the tax base and eliminating many current tax expenditures. These proposals would reduce the incentives for taxpayers to engage in tax-favored activities, such as the utilization of employment-based benefits. The two largest employee benefits are health insurance and pension plans, each of which reduces current federal income tax revenues by nearly $60 billion per year. This discussion focuses on the consequences of fundamental tax reform for employment-based health insurance. Such insurance accounted for 6.2 percent of total compensation costs in 1993.

Most of the current tax reform proposals, including the flat tax proposal by Rep. Dick Armey (R-TX) and Sen. Richard Shelby (R-AL), the national retail sales tax and the USA tax suggested by Sens. Sam Nunn (D-GA) and Pete Domenici (R-NM), would eliminate the favorable income tax treatment that is currently afforded to employment-based health insurance. Reducing the tax subsidy for such insurance could have important effects. Many academic studies have argued that by lowering the after-tax price of insurance, current tax policy leads to overinsurance by those households that purchase insurance. Some have argued that overinsurance is the starting point for the rising spiral of medical costs that has led to a doubling of medical care spending as a share of Gross National Product in the last 25 years. Other research suggests that individual decisions about purchasing health insurance, and firm decisions (especially at small firms) about whether to offer such insurance, are sensitive to its cost. Raising the after-tax price of health insurance could therefore reduce the number of individuals with such insurance.

A Framework for Measuring the Current Tax Subsidy

To define the tax subsidy to employment-based health insurance, consider an individual with a federal marginal income tax rate on earned income of t, a net-of-federal tax state income tax rate of t_s, and statutory employer and employee rates of payroll tax each equal to t_{ss}. Assume that labor income taxes and payroll taxes are fully borne by labor, so that when an employer purchases insurance for E dollars, the employee's wage is reduced by $E/(1+t_{ss})$. The change in the employee's after-tax wage income per dollar of employment-based insurance is therefore $(1-t-t_s-t_{ss})/(1+t_{ss})$. Many previous studies of taxation and employment-based health insurance have used this expression to define the tax subsidy to employment-based insurance.

While the after-tax wage reduction per dollar of employment-based insurance is a key factor determining the after-tax price of such insurance, two other factors also affect this price and hence the relative price of employment-based insurance versus self-insurance. The first is the load factor on health insurance. While this affects the level of our cost measure, it does not substantially affect our estimates of how tax reform would affect insurance demand. Second, a substantial and rising fraction of the premiums for employment-based insurance is paid for by employees. Employee contributions to group health insurance totaled $46.2 billion in 1993, or nearly 20 percent of employer contributions. Data from various Bureau of Labor Statistics' surveys suggest that approximately three-quarters of these employee premiums are paid after tax. Because the employees who must make post-tax contributions to their employment-based insurance receive favorable tax treatment of a smaller fraction of their health insurance than those employees whose insurance is fully provided by the employer, the presence of employee contributions raises the after-tax price of employment-based health insurance.

The after-tax price of insurance can be measured net of the cost of employee payments for employment-based insurance. The central comparison that we develop in Gruber and Poterba (1996b) is between the after-tax price of employment-based health insurance and the after-tax cost of self-insurance. For itemizers and potential itemizers, the cost of self-insurance is affected by the possibility of

[1] This discussion is a condensed version of Gruber and Poterba (1996a), which describes the methodology underlying the present calculations in much greater detail.

claiming an itemized deduction for medical expenses in excess of 7.5 percent of adjusted growth income; this reduces the after-tax cost of out-of-pocket medical spending and hence self-insurance.

Evaluating the Tax Subsidy

To evaluate the after-tax price of health insurance relative to self-insurance, we use the National Bureau of Economic Research's TAXSIM program to impute tax rates to family units in the 1987 National Medical Expenditure Survey (NMES). The detailed information on health insurance and health care spending in this data base is then used to analyze current tax subsidies to employment-based health insurance and the potential consequences of various tax reforms. Individual NMES respondents are aggregated into "health insurance units": the family head, his or her spouse, any children under age 19, and full-time students until they reach age 23. Our sample is restricted to employed individuals in households without any members over age 65, and it excludes families with anyone who is covered by Medicaid or any missing information on insurance status.

An important source of current subsidy to employment-based health insurance purchases is the exclusion of these purchases from the Social Security/Disability (OASDI) and Medicare (HI) payroll taxes. The former provides a subsidy only to those with earnings below the taxable maximum of $60,600, while the latter subsidizes all employees. However, unlike federal and state income taxes, higher payroll taxes are associated with higher future Social Security benefits for many workers. If reduction of the current tax subsidy to employment-based health insurance led workers to demand less insurance, and firms correspondingly increased taxable wage payments, workers would be liable for higher payroll taxes but their Social Security benefits calculation would also be based on a higher stream of earnings. In evaluating the net cost of the payroll tax, we therefore compute the present discounted value of payroll taxes net of prospective benefit increases under current benefit rules. The calculations use information from Feldstein and Samwick (1992) to estimate the magnitude of these benefit linkages.

Table 14.1 summarizes the current tax subsidy to employment-based insurance. It reports the average value of the after-tax relative price of employment-based insurance under the current tax system. The first few rows show the various marginal tax rates that enter the calculation of the after-tax price of health insurance. For employed individuals with employment-based insurance, the weighted average, marginal, federal income tax rate in 1994 was 21.9 percent; state taxes contribute an additional 3.5 percent. The statutory (combined Social Security, Disability, and Medicare Hospital Insurance) payroll tax rate was 7.4 percent, slightly lower than the statutory rate of 7.65 percent because some individuals earn above the maximum taxable amount. However, because both employees and employers pay the payroll tax, this tax is roughly two-thirds as important as the income tax in contributing to the tax subsidy to employment-based health insurance. The benefit-tax linkage rate is 0.064, so the *net* payroll tax rate is 2*0.074 - 0.064 = 0.084.

When we combine the tax rates with our estimate of the load factor on employment-based insurance and information on the share of employment-based health insurance premiums that are tax deductible, we estimate that the average after-tax marginal price of employment-based health insurance is 0.806. In the absence of any tax distortions, this price would be 1.101. The current system of income and payroll taxes thus reduces the marginal after-tax price of employment-based health insurance, relative to self-insurance, by approximately 27 percent.

Now consider how the after-tax price of employment-based health insurance would be affected under the Armey-Shelby flat tax, the national retail sales tax, and the Nunn-Domenici USA tax. Throughout our analysis we assume that state income taxes are not affected by federal tax reform, but if they were, this would make the effects described below even larger. The key difference between Armey-Shelby or the national retail sales tax and the USA tax is that the latter provides a payroll tax credit. This largely undoes the current subsidy effect of the payroll tax, so that under the USA tax, virtually all of the tax subsidy would disappear and, except for possible state income tax subsidies, the relative price of employment-based health insurance would be similar to that in a world with no income taxes.[2]

The penultimate row of table 14.1 shows the effect of eliminating the federal income tax wedge between wage income and employment-based health insurance, as under the Armey-Shelby plan or the national retail sales tax. The marginal after-tax cost of employment-based insurance averages 0.972 for currently employed insured workers, which corresponds to a 12 percent subsidy relative to the no-tax value. This represents a 21 percent price increase

[2] In Gruber and Poterba (1996a), we discuss the fact that the USA tax provides a credit for the full statutory payroll tax, but with benefit-tax linkage, the effective tax burden is only a fraction of the statutory rate. This can lead to a tax on employment-based health insurance vis-a-vis out-of-pocket medical spending.

Table 14.1
TAX SUBSIDY TO EMPLOYMENT–BASED INSURANCE, CURRENT LAW AND PROPOSED TAX REFORMS

	Average Value for Employed, Insured Workers
Marginal Federal Income Tax Rate	.219
Marginal State Income Tax Rate	.035
Payroll Tax Rate	.148
Benefit Offset to Payroll Tax	–.064
Marginal After-Tax Cost of Employer Provided Health Insurance:	
No tax world	1.101
1994 tax law	0.806
Armey-Shelby flat tax, national retail sales tax	0.972
Nunn-Domenici USA tax	1.111

Source: Jonathan Gruber and James M. Poterba, "Fundamental Tax Reform and Employment-based Health Insurance," in Henry Aaron and William Gale, eds., *Fundamental Tax Reform* (Washington, DC: The Brookings Institution, 1996). Entries reflect averages in the population of employed insured workers, based on data from the National Medical Expenditure Survey for 1987.

relative to the current after-tax price of employment-based insurance. The substantial tax subsidy to employment-based health insurance that remains under these income tax reform plans is primarily due to the continued exclusion of employment-based health insurance from the payroll tax base.

The last row in table 14.1 presents an estimate of how the USA tax would affect the after-tax price of employment-based health insurance. For employed insured individuals, the after-tax price rises to 1.111, actually higher than the price in a no-tax world. This is because the payroll tax credit offsets the statutory payroll tax rate and in effect overcorrects for the payroll tax net of benefit linkage. The USA tax therefore raises the average after-tax cost of health insurance by approximately 38 percent.

TAX REFORM AND THE DEMAND FOR INSURANCE

The previous calculations suggest that current proposals to alter the federal tax structure could substantially reduce the tax subsidy to employment-based health insurance. To assess how such subsidy changes could affect the demand for employment-based insurance, we must make some assumption about how the amount of health insurance spending will respond to price changes. It is particularly important to distinguish between the component of spending response that is due to a change in the number of individuals with insurance coverage and that due to a change in spending by those who are covered both before and after tax reform. Unfortunately, there is little empirical evidence to guide this decomposition. Many studies have estimated the elasticity of demand for total insurance spending and for insurance coverage, but no previous study has considered both effects simultaneously. Moreover, each of these literatures has produced a broad range of estimates without a "consensus" figure to use for illustrative computations.

Our calculations below consider two cases, one in which the overall insurance demand elasticity is -0.5 and the coverage elasticity is -0.3 and another in which the overall demand elasticity is -1.0, with a coverage elasticity of -0.5. To place the following calculations in context, it is helpful to note that Employee Benefit Research Institute tabulations from the March 1994 Current Population Survey (CPS) found that in 1993, 69.7 percent of the population under age 65 had private health insurance coverage, with 60.8 percent of the population covered through an employment-based health insurance plan. Another 16.1 percent had public health insurance, while 18.1 percent reported no health insurance (Employee Benefit Research Institute, 1995).

The findings with respect to the changes in insurance demand associated with the tax reforms are as follows. For the Armey-Shelby proposal or the national retail sales tax, with the first (lower) set of elasticities, the reduction in the tax subsidy to employment-based insurance is predicted to result in an 11.7 percent decline in total spending on employment-based health insurance and a 6.4 percent, or 8.6 million person, decline in insurance coverage. With the second set of elasticity parameters, the predicted effects of these proposals are larger: a 23.4 percent decline in insurance spending and a 10.7 percent decline (14.3 million person drop) in the number of persons covered by employment-based health insurance. The demand effects that are predicted to follow from the USA tax are even larger than those from the Armey-Shelby proposal. With the smaller set of elasticities, the estimates imply a 19.1 percent drop in employment-based insurance spending, and a 10.8 percent (14.4 million person) drop in insurance coverage. With the larger elasticity values, these changes rise to a 38.3 percent decline in insurance spending and a 24.1 million person decline in the number of employees with employment-based insurance.

The foregoing analysis treats employment-based health insurance as having only two dimensions: coverage and quantity purchased conditional on coverage. In practice, this is a dramatic simplification, since health insurance is a very heterogeneous product, with many distinct features that might respond to price changes in different ways. Unfortunately, there is virtually no empirical evidence on how changes in the after-tax price of health insurance affects policy characteristics. Any discussion of this issue is therefore speculative. One possibility, discussed in Gruber and Poterba (1996a), is that tax reform that raises the after-tax price of employment-based health insurance would reduce the demand for some types of "auxiliary care coverage" that is currently included in many employer health plans, such as dental coverage, vision coverage, and similar provisions.

One of the central issues associated with tax reform and the health insurance marketplace is whether reducing the tax subsidy to employment-based insurance would lead to a systematic shift away from work place pooling of health insurance risks. Such a shift would have far-reaching implications for health insurance more generally, ranging from changes in the cost of some employment-based benefit plans to an increase in market segmentation and potentially in the number of individuals who are unable to obtain insurance.

Pooling health insurance risks through the work place is attractive for more than just current tax benefits. Because most work place pools are large, they are able to take advantage of the economies of scale in insurance buying as well as administrative savings that result from use of payroll systems to process individual contributions to group health insurance policies. Because work place groupings are largely determined by factors unrelated to health status, insurance through the work place avoids many of the adverse selection problems that arise in other types of insurance purchasing environments. As a result of these factors, the Congressional Research Service (1988) estimates that the cost of insurance for small groups, those with fewer than 5 persons, is 35 percent more than the cost for groups with 10,000 or more members. While work place pooling might continue even if the tax subsidy to employment-based insurance were curtailed, the higher after-tax cost of such insurance might lead to a shift toward more basic coverage, possibly with increased work place segmentation in the set of workers participating in particular health insurance plans.

Conclusion

Our analysis suggests that the Armey-Shelby flat tax and the national retail sales tax would reduce the current tax subsidy to employment-based health insurance by slightly more than one-half. However, neither plan eliminates the current tax incentive to employment-based health insurance because the payroll tax subsidy to this insurance remains intact. The combined employer and employee payroll tax rate of 15.3 percent, even when by consideration of the linkage between taxes and benefits, represents a substantial subsidy and one that would encourage the present system of employment-based insurance even after fundamental tax reform. State income taxes, which currently follow the federal income tax treatment of employment-based insurance benefits and might continue to do so even after modification of the federal income tax code, would also continue to encourage employment-based insurance. The USA tax would essentially eliminate current tax subsidies to employment-based health insurance, because it eliminates the federal income tax incentive for employment-based health insurance as well as the payroll tax subsidy to this insurance.

Any of these proposals seem likely to reduce spending on employment-based health insurance and to lead to a decline in the number of individuals who are covered by such insurance. Our illustrative calculations suggest that these effects could be substantial, particularly under the USA tax.

References

Congressional Research Service. *Costs and Effects of Extending Health Insurance Coverage.* Washington, DC: U.S. Government Printing Office, 1988.

Employee Benefit Research Institute. *EBRI Databook on Employee Benefits.* Third Edition. Washington, DC: Employee Benefit Research Institute, 1995.

Feldstein, Martin S., and Andrew Samwick. "Social Security Rules and Marginal Tax Rates." *National Tax Journal,* Vol. 45 (1992): 1–22.

Gruber, Jonathan, and James M. Poterba. "Fundamental Tax Reform and Employment-based Health Insurance." In Henry Aaron and William Gale, eds., *Economic Effects of Fundamental Tax Reform.* Washington, DC: The Brookings Institution (1996a).

Gruber, Jonathan, and James M. Poterba. "Tax Subsidies to Employment-based Health Insurance." In Martin Feldstein and James Poterba, eds., *Empirical Foundations of Household Taxation* Chicago, IL: University of Chicago Press, 1996b.

15. Comprehensive Tax Reform and Employment-Based Health Insurance

by David M. Cutler

Introduction

Comprehensive tax reform may have the most dramatic effect on the medical care marketplace of any initiative since World War II. An Internal Revenue Service ruling in 1943 that health insurance costs were not to be taxed as income created a distinction between employment-based health insurance and wages: both are deductible at the corporate level, but only wages are taxed to the individual. As a result, employees receive an income tax subsidy of around 20 cents on each dollar of health insurance purchased and a payroll tax subsidy of around 10 cents. This tax subsidy has had an enormous effect on the health care marketplace. Currently, nearly $70 billion annually is not collected by the federal government because health insurance is not taxed through income or Social Security taxation. The tax subsidy has led to the entire system of employment-based health insurance, to generous (and expensive) health insurance coverage, and to the provision of medical services far beyond the efficient level (Pauly, 1986; Cutler, 1996b).

Comprehensive tax reform promises to change all that. By eliminating the tax subsidy to health insurance, incentives toward excessive medical spending would be reduced. The dependence of workers on employment-based insurance would fall. There would be less pressure for excessive medical care provision. On the surface, this seems beneficial: why subsidize health insurance and not other goods? Couldn't we use the money better elsewhere? Indeed, the tax subsidy to health insurance seems particularly hard to justify when there is nearly universal agreement that the United States spends too much on medical care.

But if these are the benefits of comprehensive tax reform, there are costs as well. This discussion considers the implications of comprehensive tax reform for the medical care marketplace. The point is not to argue for or against comprehensive tax reform but simply to look at some of the implications of reform. I first consider how the subsidy for health insurance would be eliminated and then turn to the economic effects of this change.

Taxing Employment-Based Health Insurance

The simplest conceptual experiment for comprehensive tax reform is to treat health insurance just like wages, leaving it deductible for firms but making it taxable for workers. However, a moment of thought suggests that this is easier said than done. In a group insurance policy, what is the benefit that each employee receives? Do sick workers receive more health insurance than healthy workers? What about older workers versus younger workers? Certainly the *dollar* value of employer spending differs across workers in these examples, but the particulars of the *insurance package* may be the same. Which should be taxed? For a product that is purchased at the group level, there is fundamentally no way to allocate the spending to each individual exactly.

There are two possibilities if one wants to tax health benefits at the individual level. The first is to arbitrarily divide spending across employees and allocate that amount to each worker. For example, the implicit income of each worker could be total benefit costs divided by the number of employees (perhaps adjusted for choice of individual versus family policies). This is conceptually simple, but the simplicity comes at the expense of large inequities across and within firms. In the past, these inequities have drawn large opposition.

The second approach is to impute the *actuarial value* of each insurance policy. The actuarial value is the hypothetical cost of the policy if the average person in the country were in the policy. In a world of fee-for-service insurance, where demand is limited by cost sharing that the worker faces and the set of covered services, this makes sense. However, it makes much less sense in the managed care world, where spending is limited by restricted choice of providers and providers are induced to perform less care through utilization management and financial incentives. However, even if one could deal with these managed care complications, the history of sec. 89 almost certainly rules out suggestions to require widespread calculations of actuarial values.

If health insurance costs are not to be imputed to each worker, the alternative is to disallow the deduction of health insurance payments by firms. This is administratively simpler than taxing health benefits at the employee level, since no individual recordkeeping or enforcement is required. However, eliminating the deductibility of health insurance payments creates substantial adverse incentives for hiring low wage workers. To see this, consider the version of the flat tax proposed by magazine publisher and former presidential candidate Steve Forbes—where a family of four pays no tax on income up to $36,000. Income above $36,000 is taxed at 17 percent, as are corporate profits.

Suppose that a family of four has one worker who earns $25,000 in total compensation. If the firm pays the $25,000 entirely as wages, there is no tax. However, if $5,000 is paid as health insurance, there is a tax at the corporate level of $850 ($5,000 X .17). For a high wage worker (above $36,000), in contrast, the $5,000 would be taxed at a 17 percent rate regardless of whether it is paid as health insurance or wages.

Disallowing the corporate deduction thus leaves the high wage worker indifferent between receiving income in the form of health insurance or in the form of wages. However, there would be a substantial *disincentive* to hire low wage workers if the firm is providing health benefits. The tax on low wage workers would be $850—not a small amount. Today, low wage workers have a hard time finding employment in firms that provide health insurance, even with the tax subsidy (Cutler and Madrian, 1996). I don't think we want to compound this by taxing the provision of health insurance, particularly for these workers.

One could try to ameliorate these effects with a credit for firms that provide health insurance to low wage workers, but this just gets back to the previously discussed problem of imputing health benefits to particular workers. Disallowing the deductibility of employment-based health insurance thus seems to me to be a nonstarter.

Table 15.1
RESPONSIVENESS OF INSURANCE DEMAND TO PRICE

Margin	Short Run	Long Run
Generosity of Benefits	–0.3	>–0.3
Coverage Decision	–0.5	>–0.5
Low wage	>–1	?
High wage	<–0.1	?

Source: David M. Cutler.

In short, there is no ideal way to level the playing field between health insurance and wages. We cannot adopt the policy that we would like (imputing the actuarial value of health insurance to workers), and we almost certainly do not want to adopt the policy that is easiest (disallowing the deductibility of employer payments). The only reasonable solution, if health insurance benefits are to be taxed, is to impute average spending to workers, as crude as that may be.

ECONOMIC IMPLICATIONS OF TAXING EMPLOYMENT-BASED HEALTH INSURANCE

Suppose that we could perfectly tax employment-based health insurance benefits at the individual level. What would the economic effects of such a tax change be? One effect, which is beneficial, is that employees would have incentives to choose less generous insurance policies. By subsidizing health insurance payments, we increase the incentives for firms to offer very generous policies and reduce the incentives for employees to shop carefully among health insurance plans. For example, if an employee is choosing between two plans that differ in price by $100 but premiums are paid for on a pretax basis, the exclusion of health benefits from income taxation reduces the after-tax price differential to only $70 or $80. Empirical evidence suggests that choice of policies is responsive to price. Taylor and Wilensky (1983), Farley and Wilensky (1984), and Holmer (1984) estimated the elasticity of demand for the generosity of coverage at about –0.3 (table 15.1). If tax reform increased the price of health insurance by 20 percent, the generosity of insurance coverage would fall by about 10 percent. I suspect the long-run price elasticity is even larger than this, since the entire structure of the health insurance industry when employees are choosing insurance more carefully will be different from the structure of the industry today. If we create incentives for more cost conscious choice, more low cost plans will enter the market, and prices will fall with increased competition.

However, there are other effects that are less valuable. Chief among these is that many people, particularly low wage workers, will drop health insurance. Empirical estimates of the elasticity of demand for insurance (table 15.1) range from 0 to about –2, with a "consensus" estimate of –0.5 to –1 (Gruber and Poterba, 1996). For reasons detailed elsewhere, I suspect that the true elasticity is greater than –0.5 for low wage workers and smaller than –0.5 for high wage workers (Cutler, 1996b). I also suspect that the long-run elasticity is greater than –0.5, because the estimates in the literature take the set of firms as given but firms will change their configuration (outsourcing, temporary workers, etc.) in response to benefits costs.

However, if we use –0.5 as an average elasticity, the increase in the cost of health insurance would reduce the share of the population with employment-based health insurance by about 10 percent. If the elasticity were as high as –1, the increase in the uninsured population would be 20 percent. That is an enormous effect—the "dramatic" reduction in health insurance in the 1980s that got politicians so agitated was only a 5 percentage point reduction in insurance coverage. Indeed, an additional 10 percent of the population being uninsured would swell the ranks of the uninsured by over 50 percent.

What are the implications of such a decline? I think there are three. The first is that some people will try to buy insurance in the nongroup market but will be unable to do so. The nongroup market functions very poorly. Coverage is poor, prices are high, and there is generally no guarantee that people can renew their policy if they get sick.* In an insurance market prone to adverse selection and risk selection, increasing the share of the population wanting to buy nongroup insurance is bound to create difficulties. Second, public-sector spending on medical care will increase. Some of those who lose insurance will enroll in Medicaid and be paid for by the public sector. Others will remain uninsured and get care in public hospitals. And, with more uninsured people, it will be more difficult to cut Medicaid and Medicare payments to hospitals that take care of the poor. Thus, the public sector will almost certainly get more involved in the financing of medical care if the tax subsidy to health insurance is eliminated.

The third implication is a broader one for the U.S. health system. I do not think we can sustain the health system that we have if the uninsured population increases by that amount. In competitive markets, we generally do not see large transfers from providers to those too poor to purchase insurance. Supermarkets, for example, don't consider it their natural responsibility to provide free food to the poor.

The provision of uncompensated medical services was a product of the days when no one felt responsible for the bills at the margin, and the market was not very competitive.

Even in the current environment, that is changing. Private hospitals are discouraging nonpaying patients from using their facilities, and health plans are encouraging their members to attend lower cost providers—generally those without the large overhead that the uninsured bring. This bifurcation of care between the insured and the uninsured would proceed even faster if the number of uninsured increased dramatically. I suspect that, if we adopt anything like full taxation of health insurance benefits, the future of health care is the nearly complete separation of care between those who have insurance and those who do not. Currently, the uninsured receive less care than the insured (Weissman and Epstein, 1994), but the differentials are not so big; with comprehensive tax reform, the differentials between those with and without insurance will surely grow. This is a social as much as an economic issue for us to consider.

Implications for Comprehensive Tax Reform

If that is the future with comprehensive tax reform, do we want it? It seems useful to divide the discussion of the taxation of health benefits into two parts. The first is whether we want to subsidize the purchase of health insurance in any way. There is a strong case for this. We already provide large subsidies to the uninsured through Medicaid and the provision of uncompensated care. A countervailing subsidy to insurance can limit the extent of the free-rider problem.

Providing a subsidy to insurance on average is different from providing a subsidy to insurance at the margin, however. What creates the economic distortions is the fact that more generous coverage is subsidized relative to less generous coverage. Limiting the tax subsidy afforded health insurance payments to a base amount—and ending the unlimited subsidy—may serve the economic purpose of tax reform but still encourage people to purchase private insurance. This type of tax reform ought to be considered in more detail.

What is equally important is that, if we go ahead with comprehensive tax reform, we must find some way to improve the functioning of nongroup insurance markets. The prospect of a vastly increased nongroup pool, with premiums varying by health status and insurers free to pick and choose whom to cover, is not an appealing one. With or without comprehensive tax reform, this type of issue is bound to come to the forefront.

*Editor's note: In August 1996, President Clinton signed into law the Health Insurance Portability and Accountability Act, which prohibits discrimination against individuals based on any medical condition or disability at the time of plan renewal.

REFERENCES

Cutler, David. "Comment on Gruber and Poterba." Brookings Conference on Fundamental Tax Reform, Washington, DC, February 1996a.

________. "Public Policy for Health Care." Mimeo. January 1996b.

Cutler, David, and Brigitte Madrian. "Labor Market Implications of Rising Health Insurance Costs: Evidence On Hours of Work." Mimeo. February 1996.

Farley, Pamela, and Gail Wilensky. "Household Wealth and Health Insurance as Protection Against Medical Risks." In Martin David and Timothy Smeeding, eds., *Horizontal Equity, Uncertainty and Economic Well-Being*. Chicago, IL: University of Chicago Press, 1984.

Gruber, Jonathan, and James Poterba. "Fundamental Tax Reform and Employment-based Health Insurance." In Henry Aaron and William Gale, eds., *Economic Effects of Fundamental Tax Reform.* Washington, DC: The Brookings Institution, 1996.

Holmer, Martin. *Tax Policy and the Demand for Health Insurance.* Washington, DC: U.S. Department of Health and Human Services, 1984.

Pauly, Mark. "Taxation, Health Insurance, and Market Failure in the Medical Economy." *Journal of Economic Literature* (June 1986): 629–675.

Taylor, Amy, and Gail Wilensky. "The Effect of Tax Policies on Expenditures for Private Health Insurance." In Jack Meyer, ed., *Market Reforms in Health Care.* Washington, DC: American Enterprise Institute, 1983.

Weissman, Joel S., and Arnold M. Epstein. *Falling Through The Safety Net: Insurance Status and Access to Health Care*. Baltimore, MD: The Johns Hopkins University Press, 1994.