

1996

Employee Benefits and Tax Reform

Stephen A. Woodbury

Michigan State University and W.E. Upjohn Institute, woodbury@upjohn.org

Upjohn Institute Working Paper No. 96-45

****Published Version****

In *Tax Reform: Implications for Economic Security and Employee Benefits*, edited by Dallas L. Salisbury.
Washington, D.C.: Employee Benefit Research Institute, 1997, pp. 27-34

Citation

Woodbury, Stephen A. 1996. "Employee Benefits and Tax Reform." Upjohn Institute Working Paper No. 96-45. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research. <https://doi.org/10.17848/wp96-45>

This title is brought to you by the Upjohn Institute. For more information, please contact repository@upjohn.org.

Employee Benefits and Tax Reform

Stephen A. Woodbury

Revised, July 1996

Woodbury is Professor of Economics, Michigan State University, East Lansing, MI 48824 (517/355-4587, woodbur2@pilot.msu.edu) and Senior Economist, W.E. Upjohn Institute for Employment Research, 300 South Westnedge Avenue, Kalamazoo, MI 49007 (616/343-5541, woodbury@we.upjohninst.org). This paper is a revision of a paper prepared for the Employee Benefit Research Institute Policy Forum on "Comprehensive Tax Reform: Implications for Economic Security and Employee Benefits," Washington, D.C., April 30, 1996. I am grateful to Charles Ballard, Robert E. Heitzman, Patricia Reagan, and John A. Turner for helpful discussions.

Employee Benefits and Tax Reform

Stephen A. Woodbury

Revised, July 1996

Abstract

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, employer-provided 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 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 3) 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 U.S. 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.

¹ As Bradford (1986, p. 20) 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.

Current attempts to move toward a consumption tax have been welcomed 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.

Major concerns with the consumption tax have been raised by many employers, though, 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 forthcoming). First, provision of employee benefits may have externalities that enhance the productivity of workers. 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 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). But 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.

Section I below briefly discusses 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. Section II then presents some estimates of how these comprehensive tax reforms would affect (a) the coverage of workers by employer-provided pension and health-insurance plans, (b) employer contributions to pension and health insurance plans, and (c) the shares of compensation received as pensions and health insurance.

Employee Benefits and Tax Reform

Stephen A. Woodbury

Revised, July 1996

I. Proposals to Change the Tax Treatment of Employee Benefits

A common feature of recently proposed tax reforms is to eliminate 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 (a) 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 (b) 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 Senators Nunn and Domenici and flat tax proposals introduced by Representative Armey and Senators Shelby and Specter. All have the essential features of a consumption tax (Salisbury 1995; 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 Representative Gephardt's 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 (Salisbury 1995; Gruber and Poterba 1996).

The economic incentives created by eliminating the tax-favored status of employee benefits on employer- provided 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 employer- provided 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.

II. Impacts of Tax Reform on Employee-Benefit Provision

Table 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: (a) the percentage of wage and salary workers (aged 25 and older) who are covered by employer-provided pension and health insurance plans; (b) the aggregate dollar contributions by employers

to pensions and health insurance plans; and (c) the share of total compensation received by workers as pensions and health insurance.²

Column 1 of Table 1 shows actual levels of employee coverage, employer contributions, and compensation shares in 1993-94—that is, under the existing income tax in which pension plan contributions are tax-deferred and health insurance contributions are tax-free. Columns 2, 3, 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 Representative 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 form 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 Senators Nunn and Domenici in their USA Tax and by Representative Armev and Senators Shelby and Spector in their flat tax proposals.

Each of the simulated changes in Table 1 should be thought of as a point estimate that has some error and uncertainty associated with it. Accordingly, each point estimate in Table 1 is accompanied by an estimated simulation error in parentheses.³ 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 discussion below, each point estimate is reported with its simulation error in parentheses—for example, the decrease in pension

² The simulations presented in Table 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.

³ 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 1.

coverage that follows adoption of a consumption tax is reported as "5.5 percentage points (\pm 2.3 percentage points)."

Two types of simulation underlie the estimates in Table 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 those 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 older 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 .24 to .30 percentage points for pensions and by about .1 to .13 percentage points for health insurance.⁴ The coverage simulations are discussed further in subsection A below.⁵

The simulated changes in employer contributions to pensions and health insurance (the middle two rows of Table 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, tables 6.3C and 6.11C). 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

⁴ 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.

⁵ 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).

estimating procedure.) The employer contribution and compensation share simulations are discussed in subsection B.⁶

A. Effects on Employee Coverage

The rows of Table 1 labeled Employee Coverage show, first, that 57 percent of wage and salary workers in 1993 were covered by an employer-provided pension plan and that nearly 68 percent were covered by employer-provided 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 .8 percentage points ($\pm .7$ 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 Representative 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).

⁶ The differences between the simulated changes under a reformed income tax (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—that is, 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 growth that advocates of the consumption tax promise). In large part, these assumptions are based on political considerations; that is, 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).

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 1 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 employer-provided pension, and the 2.3 percentage point reduction in health insurance coverage implies that nearly 3 million fewer workers would be covered by employer-provided 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 employer-provided pension plan and over 64 percent would remain covered by an employer-provided 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 1. What are we to believe? There are two weaknesses inherent in the behavioral estimates that are the basis of the simulations reported in Table 1. 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 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 law-makers 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: 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.

B. Effects on Employer Contributions and Compensation Shares

The middle rows of Table 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 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 (\pm \$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—see column 3. Health insurance contributions would fall by about \$38.7 billion (\pm \$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 (\pm \$6.7 billion), or nearly 50 percent, and would reduce employer contributions to health insurance by \$52.9 billion (\pm \$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.⁷

Finally, column 5 simulates the impact of a consumption tax in which employer contributions to health insurance are treated as consumption (the Nunn-Domenici and Armev-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 (\pm \$6.8 billion), or nearly 40 percent in 1994. Also, employer contributions to health insurance would have dropped by \$31.8 billion (\pm \$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 in which health insurance contributions were treated as consumption (the Nunn-Domenici and Armev-Shelby-Spector proposals) would dramatically reduce employer contributions to pensions and health insurance. Would the effects of these changes on the well-being of workers 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

⁷ The share of health insurance would remain roughly constant, even though expenditures would fall, because of the drop in pension contributions.

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 of retirement saving. The ready availability of tax-favored retirement saving to all workers, not just to those employed and covered by an employer-provided plan, suggests that the implications of the consumption tax for the distribution of retirement income could be salutary.⁸

Available empirical evidence gives some indication of whether workers would in fact save and provide adequately 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 and 60 percent of pension contributions represent net additions to saving (as opposed to 80 to 100 percent, as many earlier studies found). In other words, reductions in pension contributions would reduce net retirement savings substantially—by 20 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 employer-provided 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.

⁸ There are, of course, tax-favored vehicles of retirement saving now available to the self-employed (Keough plans) and to workers who are not covered by an employer-provided 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.

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 employer-provided health care can be expected to stem the growth of the health care sector.

As already 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 to 14 years old and have a sizable degree of uncertainty associated with them (as reported in Table 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.

III. Summary

The story told by the simulations shown in Table 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 and 9 percentage points and health insurance coverage by between .5 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 employer-provided 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, Massachusetts: Harvard University Press, 1986.
- 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, The Brookings Institution, June 1995.
- Gruber, Jonathan and James Poterba. "Fundamental Tax Reform and Employer-Provided Health Insurance." Paper prepared for the Brookings Institution Conference on Fundamental Tax Reform, February 1996.
- Heitzman, Robert E., Jr. "Pensions in a Flat World." Issue Brief. Washington, D.C.: 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, Wisconsin: IRRA, 1989. Pp. 374-386.
- Reagan, Patricia B. and John A. Turner. "Youth, Taxes, and Pension Coverage." Manuscript, Department of Economics, Ohio State University, August 1994.
- Rosen, Sherwin. "Does the Composition of Pay Matter?" In *Employee Benefits, Labor Costs, and Labor Markets in Canada and the U.S.*, edited by W.T. Alpert and S.A. Woodbury. Kalamazoo, Michigan: W.E. Upjohn Institute, 1996.
- Salisbury, Dallas L. "Employee Benefits in a Flat Tax or Consumption Tax World." EBRI Notes, volume 16, number 9 (Employee Benefit Research Institute, September 1995).
- Salisbury, Dallas L., Ken McDonnell, and Edina Rheem. "The Changing World of Work and Employee Benefits." EBRI Issue Briefs, Number 192 (April 1996).
- Silverman, Celia and others. *EBRI Databook on Employee Benefits*, third edition. Washington, D.C.: Employee Benefit Research Institute, 1995.

Snider, Sarah C. and Paul Fronstin. "Source 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 *Structural Changes in U.S. Labor Markets: Causes and Consequences*, edited by R.W. Eberts and E.L. Groshen. Armonk, New York: M.E. Sharpe, 1991. Pp. 105-138.

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

Table 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)¹

Tax Treatment of Employer <u>Contributions</u> :	(1)	(2)	(3)	(4)	(5)
to Pension Plans:	Deferred	Deferred	Deferred	Taxable	No Advantage
to Health Insurance Plans:	<u>No Tax</u>	<u>Low tax cap</u>	<u>Taxable</u>	<u>Taxable</u>	<u>Taxable</u>
Employee Coverage ² (%):					
Pensions	57.0 (--)	-0.1 (0.1)	-0.3 (0.2)	-6.2 (2.7)	-5.5 (2.3)
Health Ins.	67.8 (--)	-0.8 (0.7)	-2.6 (2.1)	-3.1 (2.3)	-2.3 (2.0)
Employer Contributions ³ (in \$ billions) to:					
Pensions	87.7 (--)	-1.5 (.6)	-3.8 (1.8)	-42.8 (6.7)	-33.9 (6.8)
Health Ins.	263.0 (--)	-22.9 (1.7)	-38.7 (5.0)	-52.9 (9.9)	-31.8 (8.5)
Share of Total Compensation ³ (%):					
Pensions	2.4 (--)	0.0 (.1)	-0.1 (.1)	-0.9 (.2)	-0.8 (.2)
Health Ins.	7.3 (--)	0.1 (.1)	0.1 (.2)	0.0 (.3)	0.1 (.3)

Notes: 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 Armev-Shelby-Spector flat tax proposals).

1. 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.

2. Coverage figures are for 1993. See Silverman and others (1995) and Snider and Fronstin (1995). Coverage is defined as the percentage of wage and salary workers (aged 25 and older who had earnings in the previous year) included in an employer-provided pension or group health insurance plan.

3. Employer contributions and shares of total compensation are for 1994. See Survey of Current Business 76 (January/February 1996), tables 6.3C and 6.11C.

Source: Simulations based on estimates reported in Woodbury and Bettinger (1991) and Woodbury and Huang (1991).