Summary and Conclusions

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Summary and Conclusions

Our goal in this monograph has been to explore the implications for fringe benefits and tax revenues of three major changes in tax policy. The first major change we consider is the 1986 tax reform, which significantly lowered the marginal tax rates on wage income facing most households in the United States. The second is a policy of treating employer contributions to health insurance as taxable income. We consider separately the consequences of taxing all employer contributions, and of taxing only health insurance contributions over $1,125 annually. The final policy we consider is treating all employer contributions to both pensions and health insurance as taxable income. The latter two changes would contrast sharply with the current tax-favored status that employer contributions to pensions and health insurance have enjoyed in the U.S.

The Model

The approach we have taken is to estimate a consumer theoretic model of fringe benefits that takes account of the possibilities for substitution among wages, pension benefits, and health insurance benefits. The model, which is set out in detail in chapter 2, assumes that the employer offers a menu of compensation packages to workers, who select the package that maximizes their well-being. The menu offered by employers implies certain tradeoffs between components of compensation that the employer is willing to make, and these tradeoffs depend in turn on the employer's cost of providing each benefit. The package that workers choose from the menu depends on their preferences (which depend in part on characteristics such as age and marital status), on their level of

total compensation, and on the prices of the components of compensation. The prices facing workers depend both on the employer's costs of providing each type of benefit and on the differential tax treatment of each benefit.

More formally, we follow Deaton and Muellbauer (1980a) and specify a flexible expenditure function that yields the following system of demand equations for wages, pensions, and health insurance benefits:

$$s_w = a_w + b_{wr} ln(p_r/p_w) + b_{wh} ln(p_h/p_w) + b_w ln(m/P^*) + d_{w1}x_1 + \ldots + d_{wK}x_K + u_w \quad (2.33)$$

$$s_r = a_r + b_{rr} ln(p_r/p_w) + b_{rh} ln(p_h/p_w) + b_r ln(m/P^*) + d_{r1}x_1 + \ldots + d_{rK}x_K + u_r \quad (2.34)$$

$$s_h = a_h + b_{rh} ln(p_r/p_w) + b_{hh} ln(p_h/p_w) + b_h ln(m/P^*) + d_{h1}x_1 + \ldots + d_{hK}x_K + u_h. \quad (2.35)$$

This is a standard set of demand equations, in the sense that the demand for each component of compensation is modeled as a function of the prices of those benefits, income, and other characteristics such as age and gender. In these equations, s_w, s_r, and s_h are the shares (or proportions) of total compensation received in the form of wages, pension contributions, and health insurance benefits; (p_r/p_w) and (p_h/p_w) are the prices of pensions and health insurance, relative to wages, that face workers; m is total compensation in dollars; P^* is a price index approximated by $ln\ P^* = s_w ln\ p_w + s_r ln\ p_r + s_h ln\ p_h$; x_1 through x_K are control variables other than prices and income, such as demographic characteristics, that might affect the demand for fringe benefits; and u_w, u_r, and u_h, are random disturbance terms that are assumed to be normally distributed with zero mean.

The a_i, b_{ij}, and b_i are parameters that, once estimated, can be converted into the price, income, and substitution elasticities that are needed to determine the effect of changing tax policy on the provision of the different forms of compensation (see chapter 2). The d_{ik} show the influence of the demographic and other characteristics on each compensation share, all else equal.

Two further aspects of this model deserve mention. First, the relative

prices in the demand system take account of both the employer's cost of providing each component of compensation, and the tax treatment of each component. Specifically, the relative prices are defined by:

$$p_w/p_r=(c_w/c_r)/(1-t), \tag{2.5}$$

and

$$p_w/p_h=(c_w/c_h)/(1-t), \tag{2.36}$$

where c_w, c_r, and c_h are the employer's cost of providing a unit of pension benefits, a unit of wage benefits, and a unit of health insurance benefits; and t is the marginal tax on income faced by the worker. Measurement of these relative prices is an important part of the work (see the appendix to chapter 3).

Second, earlier work on fringe benefits has examined only the choice between wages and fringe benefits taken as a whole. The demand system set out above specifies separate equations for pensions and health insurance, and hence allows examination of tradeoffs within the fringe benefit package.

Summary of Basic Estimates

In chapter 3, we report the results of estimating the model specified above using two entirely different data sets. The first is a pooled time-series of cross sections for 1969–1982 created from the unpublished two-digit industry data underlying the National Income and Product Accounts "other labor income" series (U.S. Department of Commerce, Bureau of Economic Analysis, 1986), and supplementary data bases. The second is a data base created from the 1977 Survey of Employer Expenditures for Employee Compensation (EEEC), the Current Population Survey, and supplementary data bases. We use two separate data bases in exploring tradeoffs among wages, pensions, and health insurance, because each data base has different advantages and disadvantages, and we are able to check the results of the two analyses against each other.

Our two empirical investigations agree in most important respects. In particular, they agree on the effects of income and prices (or taxes) on the mix of compensation, as follows:

(a) The demand for wage benefits is income inelastic, whereas the demand for pensions and health insurance is income elastic. Hence, a doubling of total compensation would result in less than a doubling of wage benefits, whereas the same doubling of income would more than double pension and health insurance benefits.

(b) Both pensions and health insurance are good substitutes for wage benefits and pensions are probably a better substitute for wages than are health insurance benefits. These inferences are based on point estimates of the elasticities of substitution between wages and pensions and between wages and health insurance. Formal statistical tests lend only weak support to the notion that the elasticity of substitution between wages and pensions exceeds that between wages and health insurance.

(c) Evidence on whether pensions and health insurance are substitutes or complements is relatively weak. Findings from both data sets suggest that pensions and health insurance may be complements, but in no case do statistical tests offer a strong rejection of the hypothesis that the elasticity of substitution between pensions and health insurance is zero.

It is important that the two separate investigations offer similar results about the effects of income and prices on the mix of total compensation, because these are the influences on fringe benefits that have changed most over the last 20 years. Also, it is through income and price effects that changes in tax policy make their mark on the mix of total compensation.

The two empirical analyses are in somewhat less agreement on the effects of other variables on the mix of compensation. Nevertheless, several findings in common emerge, and these can be summarized as follows.

(a) Older workers tend to receive a greater share of compensation as pensions, other things equal. But our empirical work is inconclusive about whether older workers receive more or less health insurance, other things equal.

(b) Blue-collar workers tend to receive a greater share of compensa-

tion as pensions, other things equal. But again, our empirical work is inconclusive about whether blue-collar workers receive more or less health insurance.

(c) Greater firm-specific skill increases the pension share of total compensation, and has a greater positive effect on pensions than on health insurance. This finding strongly supports the so-called agency hypothesis—that employers use deferred compensation such as pensions to create a bond between the firm and workers who have skills that can be acquired only through tenure with the firm.

(d) When we define the unit of observation as the household (as we are able to do in one of our investigations), we find that women receive a smaller share of their compensation as both pensions and health insurance, other things equal. This finding suggests the importance of including fringe benefits in future analyses of earnings differences between men and women. It also may imply that women tend to rely on the fringe benefits of other household members.

(e) In contrast to previous findings, our findings on the relationship between establishment size and the mix of compensation suggest that firm size plays a limited role in the provision of fringe benefits. This surprising finding suggests that the positive relationship between firm size and fringe benefit provision found in previous studies may be the result of an inability to control fully for income, tax-price, and other influences, and also suggests the importance of further research on the relationship between firm size and benefit provision.

Policy Simulations

In chapter 4, we report simulations of the effects on compensation of three alternative changes in tax policy: (a) the 1986 tax reform; (b) treating employer contributions to health insurance as taxable income (both a policy of taxing all health insurance contributions, and a policy of taxing only contributions over $1,125 annually); and (c) treating all employer contributions to both pensions and health insurance as taxable

income. These simulations are based on the modeling and estimation reported in chapters 3 and 4.

Effects of Policy Changes on Compensation

Tables 5.1 and 5.2 summarize the effects of the policy changes on compensation. Table 5.1 shows how each of the four simulated policy changes would have altered real expenditures on each form of compensation and compensation shares *if the policies had been in effect during 1969 through 1982*. All effects are shown in percentage terms, averaged over the 1969–1982 period. Panel A shows the total effects of the policy changes—that is, the sum of the substitution, ordinary income, and extra income effects. Panel B isolates the substitution effects of each policy change—that is, the effect of each policy if only the change in tax-price implied by each were to occur (and if real total compensation and all other independent variables were held constant).

In contrast, table 5.2 shows our estimates of how each policy change would affect real expenditures on compensation and compensation shares *if enacted under the existing tax system*. (Note that the 1986 tax reform is not shown in table 5.2 because comparison of each policy change is with respect to the tax system implied by the 1986 reform.) Again, all changes are shown in percentage terms, and Panel A shows the total effects of each policy change, whereas Panel B shows the substitution effects.

1. *Effects of the 1986 Tax Reform*. Our simulations suggest the following effects of the 1986 tax reform (see table 5.1). First, and most important, the tax reform can be expected to lead to significant *increases* in real expenditures and the share of compensation taken as health insurance. This increase in health insurance occurs in spite of the reduced incentive to receive compensation as health insurance that results from lower marginal tax rates on wages (that is, in spite of a negative substitution effect). *The increase in health insurance is attributable to the large income effects of the tax reform.*

Table 5.1 Summary of Effects of Policy Changes on Fringe Benefit Provision: Average Percentage Changes Under Tax Systems Existing 1969–1982

Panel A: Total Effects

Policy	Wages	Pensions	Health Insurance
Effects of 1986 Tax Reform on:			
Real Expenditures	9.4	0.9	10.4
Compensation Shares	−0.3	−1.4	7.7
Effects of Taxing Health Insurance Contributions on:			
Real Expenditures	−1.8	−5.8	−22.3
Compensation Shares	0.2	−4.7	2.2
Effects of Low Tax Cap on Health Insurance on:			
Real Expenditures	−0.4	−2.6	−13.9
Compensation Shares	0.1	−1.8	0.7
Effects of Taxing All Benefits on:			
Real Expenditures	−0.8	−64.1	−27.9
Compensation Shares	3.0	−53.9	−2.4

Panel B: Substitution Effects

Policy	Wages	Pensions	Health Insurance
Effects of 1986 Tax Reform on:			
Real Expenditures	1.6	−18.5	−6.1
Compensation Shares	0.7	−13.1	0.7
Effects of Taxing Health Insurance Contributions on:			
Real Expenditures	1.0	2.8	−16.9
Compensation Shares	−0.2	−0.6	4.6
Effects of Low Tax Cap on Health Insurance on:			
Real Expenditures	0.7	1.6	−11.3
Compensation Shares	−0.1	−0.4	1.8
Effects of Taxing All Benefits on:			
Real Expenditures	4.3	−53.9	−18.2
Compensation Shares	2.4	−46.1	2.4

SOURCES: Tables 4.1, 4.5, 4.10, and 4.12.

NOTES: The figures show how replacing the tax systems in effect during 1969 through 1982 with the specified tax-policy changes would have changed real expenditures on compensation and shares of compensation. Changes are shown in annual percentage terms, averaged over the 14 years. The total effects show the sum of the substitution, ordinary income, and extra income effects. The substitution effects isolate the impact of the changing tax-price of wages, pensions, and health insurance implied by each policy change.

Table 5.2 Summary of Effects of Policy Changes on Fringe Benefit Provision: Average Percentage Changes under 1986 Tax Reform

Panel A: Total Effects

Policy	Wages	Pensions	Health Insurance
Effects of Taxing Health Insurance Contributions on:			
Real Expenditures	−0.7	−4.3	−14.7
Compensation Shares	0.1	−3.7	1.8
Effects of Low Tax Cap on Health Insurance on:			
Real Expenditures	−0.1	−1.7	−8.7
Compensation Shares	0.0	−1.5	0.4
Effects of Taxing All Benefits on:			
Real Expenditures	−0.4	−48.8	−20.1
Compensation Shares	2.2	−39.3	−1.6

Panel B: Substitution Effects

Policy	Wages	Pensions	Health Insurance
Effects of Taxing Health Insurance Contributions on:			
Real Expenditures	0.7	0.1	−11.9
Compensation Shares	−0.1	−1.5	3.1
Effects of Low Tax Cap on Health Insurance on:			
Real Expenditures	0.4	0.2	−7.4
Compensation Shares	−0.0	−0.6	1.0
Effects of Taxing All Benefits on:			
Real Expenditures	3.4	−38.7	−12.1
Compensation Shares	1.7	−33.8	1.4

SOURCES: Tables 4.6, 4.11, and 4.13.

NOTES: The figures show how the specified tax-policy changes under the 1986 tax reform would change real expenditures on compensation and shares of compensation. The total effects show the sum of the substitution, ordinary income, and extra income effects. The substitution effects isolate the impact of the changing tax-price of wages, pensions, and health insurance implied by each policy change.

Second, the 1986 tax reform will shift the mix of compensation away from pensions and toward health insurance.

Our basic predictions—that the reform will (a) increase real expenditures on health insurance and the share of compensation taken as health insurance, and (b) shift the mix of compensation away from pensions and toward health insurance—can be explained by noting three points. First, as already noted, the tax reform has large income effects that increase the demand for health insurance. Second, the demand for health insurance contributions is inelastic, or unresponsive to changes in tax-prices. Hence, raising the tax-price of health insurance will increase the share of compensation received as health insurance. Third, workers are very willing to substitute back and forth between pensions and wages. That is, the demand for pensions is highly elastic, or responsive to changes in tax-prices. It follows that raising the tax-price of pensions will reduce real expenditures on pension compensation.

The results of simulating the 1986 tax reform are troubling because they suggest that it will be difficult to bring down health insurance expenditures or the health insurance share of compensation. Indeed, because the 1986 tax reform entailed such large income effects, it has likely been an underlying cause of recent increases in the demand for health insurance, even though it has reduced the tax incentives to demand health insurance.

2. *Effects of Taxing Health Insurance Contributions*. Our simulations suggest that treating all health insurance contributions as taxable income would have a strong effect on the provision of health insurance by employers. Taxing health insurance during the 1969–1982 period would have reduced real expenditures on employer-provided health insurance by over 22 percent (table 5.1), and taxing health insurance under the current system could be expected to reduce real expenditures on employer-provided health insurance by nearly 15 percent (table 5.2).

Similarly, taxing health insurance contributions in excess of $1,125 annually (in 1982 dollars) would substantially reduce real expenditures on employer-provided health insurance. Such a policy during the 1969–

1982 period would have reduced real expenditures on health insurance by nearly 14 percent (table 5.1), and doing so under the current tax system would reduce real expenditures on health insurance by nearly 9 percent (table 5.2).

An apparent side effect of taxing health insurance contributions would be a reduction in real expenditures on wages and pensions provided by employers. These decreases result because taxing health insurance would reduce real incomes, which would lead in turn to reductions in both wages and pensions. Although neither reduction would be enormous, the decrease in pension provision should be considered in any public discussion of the merits of taxing health insurance, and ways of offsetting the decrease might be considered if it were viewed as undesirable.

3. *Effects of Taxing All Fringe Benefit Contributions*. Our simulations imply that treating all employer contributions to pensions and health insurance as taxable income would dramatically reduce the provision of both pensions and health insurance. Taxing all fringe benefits would have cut pension provision by 64 percent during the 1969–1982 period, and would cut pensions nearly in half under the current tax system. Health insurance would have been reduced by nearly 14 percent during the 1969–1982 period, and would fall by 20 percent under the current system. These results suggest that reforming the tax system to include employer contributions to both pensions and health insurance as taxable income would be politically difficult.

Another consequence of taxing all fringe benefits would be a major shift in the mix of compensation away from pensions and health insurance and toward wages. The share of compensation received as pensions would be most affected—our simulations suggest a decrease in the pension share of nearly 40 percent.

Pensions are devastated by taxing all fringe benefits, but health insurance is cut by only 20 percent, for a simple reason: Pensions and wages are better substitutes than are health insurance and wages. It follows that when pensions are taxed, workers are readily willing to

substitute wages for pensions, but less willing to substitute wages for health insurance.

Effects of Policy Changes on Revenues

Appendix table A4.1 shows how each tax policy change considered would alter revenues collected under the federal personal income tax. All changes are in percentage terms, and the table shows both aggregate revenue effects and the effects on the tax bill of the average worker in low-wage, medium-wage, and high-wage industries. (We consider these industry disaggregations under "Distributional Effects" below.)

The 1986 tax reform is predicted to decrease revenues from the federal personal income tax by over 21 percent (top panel of table A4.1). Interestingly, this revenue loss could be nearly recouped by taxing all fringe benefits—the simulations suggest that taxing all fringe benefits under the current system would increase revenues by 17.6 percent (bottom right panel of table A4.1).

The simulated revenue effects of taxing only employer contributions to health insurance are less dramatic, but appear substantial nevertheless. Taxing all health insurance contributions under the current system would increase income tax revenues by over 8 percent annually. Taxing health contributions over $1,125 would increase income tax revenues by 1.5 percent.

Distributional Effects of the Policy Changes

The distributional effects of the tax policy changes can be seen in two ways. Table A4.1 shows the effect of each policy change on the tax bill of the average worker in low-wage, medium-wage, and high-wage industries. Table 5.3 disaggregates the total effects of each policy change into effects on workers in low-wage, medium-wage, and high-wage industries.

The simulations suggest that the effects of the 1986 tax reform are roughly proportional across industries. Both the revenue effects and the

Table 5.3 Effects of Policy Changes on Real Expenditures on Components of Compensation, by Industry Group

Panel A: Average Percentage Changes Under Tax Systems Existing 1969–1982

Policy/Industry	Wages	Pensions	Health Insurance
1986 Tax Reform:			
Aggregate	9.4	0.9	10.4
Low-Wage Industries	5.0	1.9	8.2
Medium-Wage Industries	8.9	0.5	11.3
High-Wage Industries	13.5	0.7	10.4
Taxing Health Insurance Contributions:			
Aggregate	−1.8	−5.8	−22.3
Low-Wage Industries	−0.7	−1.9	−20.0
Medium-Wage Industries	−1.5	−6.0	−19.9
High-Wage Industries	−2.9	−5.6	−26.2
Low Tax Cap on Health Insurance:			
Aggregate	−0.4	−2.6	−13.9
Low-Wage Industries	−0.0	−0.6	−2.5
Medium-Wage Industries	−0.0	−1.5	−7.4
High-Wage Industries	−1.1	−3.7	−22.3
Taxing All Benefits:			
Aggregate	−0.8	−64.1	−27.9
Low-Wage Industries	0.8	−81.1	−19.8
Medium-Wage Industries	−0.2	−70.2	−24.9
High-Wage Industries	−3.0	−57.2	−32.7

Panel B: Percentage Changes Under 1986 Tax Reform

Policy/Industry	Wages	Pensions	Health Insurance
Taxing Health Insurance Contributions:			
Aggregate	−0.7	−4.3	−17.3
Low-Wage Industries	−0.4	−5.9	−12.8
Medium-Wage Industries	−0.5	−4.7	−13.9
High-Wage Industries	−1.1	−3.7	−15.9
Low Tax Cap on Health Insurance:			
Aggregate	−0.1	−1.7	−8.7
Low-Wage Industries	−0.0	−0.5	−1.7
Medium-Wage Industries	−0.0	−0.9	−5.1
High-Wage Industries	−0.3	−2.5	−13.5
Taxing All Benefits:			
Aggregate	−0.4	−48.8	−20.1
Low-Wage Industries	−0.9	−68.4	−15.9
Medium-Wage Industries	−0.7	−52.3	−16.7
High-Wage Industries	−2.8	−42.9	−23.9

SOURCES: Tables 4.1, 4.5, 4.6, 4.10, 4.11, 4.12, and 4.13.

NOTES: The figures show how the specified tax policy changes would alter real expenditures on compensation. Panel A shows changes under the tax systems in effect during 1969–1982. Panel B shows changes under the current tax system. All changes are total effects (sum of substitution, ordinary income, and extra income effects) in annual percentage terms.

effects of the reform on compensation appear to be similar across industries.

Similarly, the distributional effects of taxing all health insurance contributions are not dramatic. Workers in low-wage industries would experience somewhat smaller decreases in wages and health insurance than workers in high-wage industries. Also, workers in high-wage industries would experience somewhat larger increases in their income tax bills. But the differences among the three groups of workers are not great.

In contrast, the distributional effects of taxing health insurance contributions over $1,125 are significant. Under the low tax cap, workers in high-wage industries would experience a 13.5 percent decrease in health insurance, whereas workers in low- and medium-wage industries would experience a decrease of only 2 to 5 percent. Also, the income taxes of workers in high-wage industries would rise by over 4 percent, whereas the income taxes of other workers would rise by less than 1 percent. We conclude that a low tax cap on health insurance has distributional effects that would increase income equality.

Similarly, the simulations suggest that taxing all health insurance contributions would tend to increase income equality. Workers in low-wage industries would experience income tax increases of 14 to 15 percent, whereas workers in high-wage industries would experience tax increases of nearly 26 percent.

Implications for Public Policy

A multitude of public policy issues currently surround the tax treatment of employee benefits. In particular, the tax-favored status of employer contributions to pensions and health insurance has been blamed for numerous ills: a shrinking tax base that has exacerbated the federal budget deficit; an inefficient and bloated health care sector, overinsurance by many recipients of employer-provided health insurance, and rising health care costs; and a tax system that is made more

regressive because those who receive tax-favored fringe benefits tend to be in higher-income households than those who do not.

In addition to being held responsible for these perceived ills, the tax-favored status of fringe benefits is implicitly blamed for failing to solve completely the problems one would expect it to address. Why do some workers still lack health insurance coverage? Why do many lack private pensions? Why, if tax-favored treatment of pension contributions is responsible for the growth of private pensions, is the rate of private saving in the United States nevertheless so low by international standards?

Some Options

Policies suggested to deal with these perceived problems have often addressed one problem without handling another. Two such proposals are (1) taxing all employer contributions to pensions and health insurance, and (2) requiring employers to provide some minimum level of health insurance to all employees—mandated health benefits. We discuss each in turn.

1. *Taxing All Fringe Benefit Contributions.* We suggest that the taxation of all employee benefits is too sweeping a policy change to implement in the foreseeable future. Our estimates suggest that taxing all employer contributions would cut in half employer contributions to private pension plans. Perhaps the simplest implication of this finding is that a policy of taxing all fringe benefits would be politically difficult to implement.

Even if it were not a politically difficult option, our findings suggest that taxing all benefits would dramatically reduce retirement saving through the private pension system, and it is not at all clear that this would be desirable. First, the U.S. economy has a low rate of private saving by international standards, and a policy that would further reduce private saving would be counter to the goal of long-run economic growth (Seidman 1990). Second, taxing all benefits would, by cutting in half the size of private pension contributions, place on the public retirement

system an increased long-run burden. If policymakers wish to tax pension contributions, they must in turn be willing either to increase the size of the social security system, or to see the income replacement rates of retirees fall substantially. Neither of these alternatives seems desirable or easy to defend.

In short, because its effects on the private pension system appear to be so dramatic, the policy of taxing all fringe benefits seems both politically infeasible and economically unwise.

2. *Mandated Benefits*. The idea of mandating health benefits has recently caught the attention of the public and many policymakers. A full treatment of mandated health benefits is beyond the scope of this discussion, but three points should be made. First, discussions of mandated benefits often seem to imply that mandating would do away with the problem of uninsured *individuals*, when of course mandating would only do away with the problem of uninsured *workers*. It follows that mandated health insurance is an incomplete policy that would need to be supplemented by a large and expensive public program of health care provision to individuals who would remain uninsured. Only rarely have advocates of mandated health insurance clearly specified the nature of the problem posed by the uninsured, or clearly delineated who would and who would not benefit from mandated benefits (but see Goddeeris 1991). The degree to which mandating would be an efficient way of solving the social problem posed by uninsured individuals is largely an unanswered question.

Second, the effects of mandated benefits on labor markets, especially low-wage labor markets, have yet to be examined in any systematic way. It seems likely that mandated benefits could have the same adverse effects on employment of low-wage workers as a large increase in the minimum wage, but the needed research on this question does not exist.

Third, mandating health care benefits could contribute to further increases in health care costs, and further inefficient use of the health care system. The reason is that, to the extent mandating is successful in extending health insurance to currently uninsured workers and households, it would increase use of the health care system. In part, such an

increase would be desirable, but (depending on the package of benefits mandated) it is also possible that further overuse of health services would result.

We conclude that the case for mandating health insurance benefits is far from clear-cut at this time. Too little research, either theoretical or empirical, has been conducted to offer a well-reasoned judgement. What is clear is that mandating benefits, like the favorable tax treatment of health insurance contributions, may create its own set of problems without providing a complete solution to the problems it is intended to address.

A Proposal for Marginal Change

We believe that a relatively low tax cap on health insurance contributions would be a sensible and efficiency-improving policy. A policy of taxing employer contributions to health insurance in excess of a relatively low amount ($1,125 annually, for example, as simulated in chapter 4) has at least five points in its favor.

First, it partially addresses the problems of rising health care costs, overuse of the health care system, and an inefficiently large health care sector. It does so by reducing the incentive for employers to provide compensation in the form of health insurance beyond a given level. As a result, the health insurance provided by employers would be more likely to be true insurance against large and unexpected health expenses, rather than simply a tax subsidy to consumption of health care services that are regular and predictable.

Second, a low tax cap on health insurance addresses the concern that the tax base will continue to be eroded as health care costs rise, and as employer contributions to health insurance increase. Many predictions, including ours, suggest that employer contributions to health insurance will continue to rise in real terms. By limiting the extent to which employer contributions to health insurance are excluded from the tax base, erosion of the tax base would be halted.

Third, a low tax cap on health insurance would *not* limit or reduce access to *basic* health care by any currently insured or potentially

insurable worker. It would likely reduce the degree to which workers who are currently overinsured consume health care services. That is, it would tend to reduce the provision by employers of extremely generous insurance that covers regular and predictable health care (Phelps 1984–85). But again, the low tax cap would be unlikely to reduce workers' coverage by employer-provided major medical insurance.

Fourth, in reducing the provision of health insurance for regular and predictable health care, the low tax cap would imply an improvement in the equity of the tax system. Our simulations suggest strongly that a low tax cap on health insurance contributions would have a favorable distributional impact. Because workers who have the highest total compensation tend to be covered by the most generous employer-provided health insurance, taxing health contributions over a specified maximum would be a progressive tax measure.

Fifth, a low tax cap on health insurance contributions would not foreclose the option of mandating health insurance benefits, should policymakers choose to pursue mandating. If all health insurance contributions were taxed, it would be extremely awkward to mandate health insurance coverage because the two policies would tend to work at cross purposes. Taxing benefits above the mandated level would not pose this problem, however. Essentially, a policy of mandating *with* taxation of benefits over a specified level could be viewed as a statement of what level of health insurance benefits is in the public interest. But again, the case for mandating health insurance is not clear-cut at present.

In short, a low tax cap on health insurance contributions would tend to alleviate each of the perceived problems outlined above without exacerbating other problems or shutting out other policy options. Accordingly, we believe the low tax cap to be a sensible and economically sound policy, and would urge its adoption.

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