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FRINGE BENEFITS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON

TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

JULY 26, 27, AND 30, 1984

Part 1 of 2

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CONTENTS

ADMINISTRATION WITNESSES

PUBLIC WITNESSES

FRINGE BENEFITS

THURSDAY, JULY 26, 1984

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:31 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Dole, Packwood, Chafee, and Symms.

[The press release announcing the hearing, An Overview of the Tax Treatment of Fringe Benefits by the Joint Committee on Taxation, and Senator Dole's and Senator Chafee's statements follow:]

[Press release No. 84-148, June 4, 1984]

U.S. SENATE, COMMITTEE ON FINANCE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, SD-219 DIRKSEN SENATE OFFICE BUILDING

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON FRINGE BENEFITS

Senator Bob Packwood, Chairman of the Subcommittee on Taxation and Debt Management, announced today that hearings will be held on Thursday, July 26, Friday, July 27 and Monday, July 30, 1984 on the issue of fringe benefits.

The hearings will begin at 9:30 each day in Room SD-215 of the Dirksen Senate Office Building.

Senator Packwood stated that "the purpose of the hearings is to develop a full, fair hearing record on current fringe benefit topics." He wishes to schedule witnesses with various viewpoints on tax policy issues surrounding fringe benefits including:

(1) Should the tax law encourage employers to provide fringe benefits; and if so, which benefits or services should be encouraged and what type and level of tax incentive is appropriate?

(2) What conditions or restrictions are appropriate on tax incentives to encourage employers to provide fringe benefits?

(3) Are the existing rules concerning fringe benefits sufficient to ensure that all employers benefit fairly from the tax incentives?

(4) Are the existing tax incentives for benefits such as health care, life insurance, day care, educational assistance, and cafeteria plans effective in encouraging employers to provide these benefits to a broad cross section of employees at a lower total cost than if the Government provided the benefits directly, if employers provided the benefits on a taxable basis, or employees purchased these benefits on their own?

(5) How will tax laws that encourage employers to provide fringe benefits affect compensation planning?

(6) Will tax incentives for employer-provided fringe benefits affect potential employees' choice of employment?

OVERVIEW OF THE TAX TREATMENT OF FRINGE BENEFITS

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ON JULY 26, 27, AND 30, 1984

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled public hearings on July 26, 27, and 30, 1984, on the Federal tax treatment of fringe benefits.

In the press release announcing the hearings, Subcommittee Chairman Packwood stated that "the purpose of the hearings is to develop a full, fair hearing record on current fringe benefit topics." As listed in the press release, these issues include the following:

"(1) Should the tax law encourage employers to provide fringe benefits; and if so, which benefits or services should be encouraged and what type and level of tax incentive is appropriate?

"(2) What conditions or restrictions are appropriate on tax incentives to encourage employers to provide fringe benefits?

"(3) Are the existing rules concerning fringe benefits sufficient to ensure that all employees benefit fairly from the tax incentives?

"(4) Are the existing tax incentives for benefits such as health care, life insurance, day care, educational assistance, and cafeteria plans effective in encouraging employers to provide these benefits to a broad cross section of employees at a lower total cost than if the Government provided the benefits directly, if employers provided the benefits on a taxable basis, or employees purchased these benefits on their own?

"(5) How will tax laws that encourage employers to provide fringe benefits affect compensation planning?

"(6) Will tax incentives for employer-provided fringe benefits affect potential employees' choice of employment?"

The first part of the pamphlet is a summary. This is followed by a more detailed overview of the Federal tax treatment of fringe benefits. The final part sets forth background information, including revenue implications of the tax treatment of certain statutory fringe benefits. This pamphlet does not describe the statutory exclusion for employer contributions to qualified pension, profit-sharing, or stock bonus plans, qualified annuity plans, or tax-sheltered annuity plans.

I. SUMMARY

In general

The Code defines gross income for income tax purposes as including "all income from whatever source derived" and specifies that it includes "compensation for services" (sec. 61). Similarly, the social security and unemployment insurance payroll taxes (FICA and FUTA) and income tax withholding generally apply to all remuneration for employment, including noncash remuneration.

The Economic Recovery Tax Act of 1981 (P.L. 97-34) extended through December 31, 1983, a moratorium on the issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits. The Treasury Department has announced that Treasury and the IRS "will not issue any regulations or rulings altering the tax treatment of nonstatutory fringe benefits prior to January 1, 1985," and that "present administrative practice will not be changed during this period" (Ann. 84-5, 1984-4 I.R.B. 31).

Statutory fringe benefit provisions

As a general rule, if an employer-provided fringe benefit program qualifies under a specific statutory provision of the Code, then the benefits provided under the program are excludable (generally, subject to dollar or other limitations) from the employee's gross income for income tax purposes. The costs of benefits that are excluded from an employee's income nonetheless are deductible by the employer provided that they constitute ordinary and necessary business expenses. The income tax exclusions also generally apply for payroll tax purposes.

The Code provides specific exclusions, among others, with respect to employer provision of (1) up to $50,000 of group-term life insurance; (2) up to $5,000 of death benefits; (3) accident or health benefits; (4) parsonage allowances; (5) certain benefits provided to members of the Armed Services; (6) meals and lodging for the convenience of the employer; (7) legal services; (8) commuting through use of a van pool; and (9) dependent care assistance.

Miscellaneous fringe benefits

Under the Tax Reform Act of 1984 (P.L. 98-369), certain miscellaneous fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage and benefit base for purposes of social security and other employment taxes. The excluded fringe benefits are those that qualify under one of the following five categories as defined in the Act: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, (4) a de minimis fringe, or (5) a qualified tuition reduction. Special rules apply with respect to certain parking or eating facilities provided to employees, and certain on-premises athletic facilities.

In the case of a no-additional-cost service, a qualified employee discount, a subsidized eating facility, or a qualified tuition reduction, the exclusion applies with respect to benefits provided to officers, owners, or highly compensated employees only if the benefits are also made available to other employees on a nondiscriminatory basis.

The provisions of the Act generally take effect on January 1, 1985, except that the tuition reduction exclusion applies with respect to education furnished after June 30, 1985. Also, the Act imposes a moratorium, with respect to lodging furnished after December 31, 1983, and before January 1, 1986, on the issuance of income tax regulations providing for the inclusion in gross income of qualified campus lodging.

Taxable fringe benefits

Any fringe benefit that does not qualify for exclusion under the 1984 Act or under another specific statutory provision is includible in gross income, and subject to employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit.

Benefits provided under a cafeteria plan

Under a cafeteria plan, a participant is offered a choice between cash and certain fringe benefits. Under prior law, a participant in a cafeteria plan could choose among cash, taxable benefits (such as use of on employer-provided vacation facility), and nontaxable benefits (such as coverage under an accident and health plan). The participant is not treated as having received cash or a taxable fringe benefit solely because the participant has the opportunity, before the benefit becomes available to the participant, to choose among the taxable and nontaxable benefits offered under the plan.

On February 10, 1984, the IRS issued a news release (IR-84-22) that stated that so-called "flexible spending arrangements" offered as part of a cafeteria plan did not provide employees with nontaxable benefits under the Code because, under such arrangements, employees are assured of receiving the benefit of what they would have received had no covered expenses been incurred. In May, 1984, the IRS issued proposed regulations with respect to the cafeteria plan rules and the statutory rules governing the exclusion of benefits from gross income.

The Tax Reform Act of 1984 limited an individual's choices under a cafeteria plan to cash and those fringe benefits (other than scholarships or fellowships, van pooling, and those benefits excludable under the miscellaneous fringe benefit provisions of the Act) that are excludable under a specific provision of the Code. The Act also amends the cafeteria plan rules to provide that if, for a plan year, more than 25 percent of the total nontaxable benefits are provided to key employees, the key employees will be taxed as though they received all available cash and taxable benefits under the plan. The Act imposes certain reporting requirements on employers maintaining cafeteria plans.

The cafeteria plan provisions of the Act are effective on January 1, 1985. In addition, the Act provides transition relief from the application of some requirements of the proposed regulations up to January 1, 1985, or, in some cases, July 1, 1985.

Welfare benefit plans

The Tax Reform Act of 1984 modified the tax treatment to employers of certain benefits provided to employees under a welfare benefit plan. Under the Act, deductions for contributions to a welfare benefit fund are limited to qualified costs, defined as the sum of (1) qualified direct costs and (2) additions, within limits, to a qualified asset account. In general, the qualified asset account limit is the amount estimated to be necessary under actuarial assumptions, which are reasonable in the aggregate, to fund the liabilities of the plan for the amount of claims incurred but unpaid to provide certain benefits and the administrative costs of such benefits. In addition, the Act provides that the qualified asset account may include amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that the medical benefit or life insurance (including death benefit) payable to or on behalf of a retired employee during retirement.

Also, the Act modifies the rules relating to the unrelated business taxable income of VEBAs, SUBS, social clubs, or GLSOs and establishes new nondiscrimination standards for a tax-exempt VEBA, etc.

These provisions of the Act generally are effective for contributions paid or accrued after December 31, 1985. A special effective date is applied to plans maintained pursuant to a collective bargaining agreement in effect on July 1, 1985. In addition, the Act provides certain transition rules with respect to existing reserves. The provisions of the Act relating to nondiscrimination requirements apply to taxable years beginning after December 31, 1984.

II. DESCRIPTION OF TAX TREATMENT OF FRINGE BENEFITS

A. Statutory Fringe Benefit Provisions

In general

Gross income, for income tax purposes, includes "all income from whatever source derived" (Code sec. 61(a)). This provision "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected" (*Comm'r* v. *Smith*, 324 U.S. 177, 181 (1945)).

As a general rule, if an employer-provided fringe benefit program qualifies under a specific statutory provision of Federal income tax law, then the benefits provided under the program are excludable (generally, subject to dollar or other limitations) from the employee's gross income for income tax purposes. The costs of benefits that are excluded from the employee's income nonetheless are deductible by the employer, provided that they constitute ordinary and necessary business expenses (Code sec. 162). The income tax exclusions also generally apply for employment tax purposes.

The Internal Revenue Code provides specific exclusions, among others, with respect to employer-provided benefits of (1) up to $50,000 of group-term life insurance; (2) up to $5,000 of death benefits; (3) accident or health benefits; (4) parsonage allowances; (5) certain benefits provided to members of the Armed Services; (6) meals and lodging for the convenience of the employer; (7) legal services; (8) commuting through use of a van pool; and (9) dependent care assistance. These fringe benefits have commonly been referred to as statutory fringe benefits.

In addition, the Tax Reform Act of 1984 provided statutory exclusions for certain other fringe benefits (see Miscellaneous Fringe Benefits, below). A provision that excluded employee educational assistance (sec. 127) from gross income expired for taxable years beginning after December 31, 1983.

Nondiscrimination rules

Under present law, exclusions for most of the statutory fringe benefits are conditioned upon compliance with rules prohibiting discrimination in favor of owners, officers, shareholders, and highly compensated employees.

These nondiscrimination rules generally prohibit discrimination as to eligibility to participate. A plan or program generally is required to meet the eligibility requirement by covering a classification of employees determined by the Internal Revenue Service not to result in prohibited discrimination. A self-insured medical reimbursement plan or group-term life insurance plan may also satisfy the requirement by covering a stated percentage of the employer's employees.

The eligibility rules generally permit employees covered by a collective bargaining agreement to be excluded from consideration if the benefits provided by the plan or program are the subject of good faith bargaining between the employer and employee representatives. The eligibility rules for self-insured medical reimbursement plans also provide that employees need not be taken into account if they have not completed three years of service, have not attained age 25, or are part-time or seasonal employees.

The present-law nondiscrimination rules applicable to certain types of fringe benefit plans and programs also prohibit discrimination as to contributions or benefits. With respect to self-insured medical reimbursement plans, present law specifically requires that all benefits available to the 5 highest-paid officers, 10-percent shareholders, or the 25-percent highest-paid employees must also be available to all other plan participants.

Under present law, if a plan is determined to discriminate in favor of employees who are officers, shareholders, or highly compensated, the otherwise applicable income exclusion generally is denied for all benefits provided under the plan, including those benefits provided for rank-and-file employees. (The nondiscrimination rules generally do not provide express guidance as to when an employee is considered highly compensated, or the extent of stock ownership required before an employee is considered a shareholder, because such factors depend on the facts and circumstances of individual cases.) However, under a discriminatory self-insured medical reimbursement plan or group-term life insurance plan, only those employees with respect to whom discrimination is prohibited are required to include amounts in gross income; other employees retain the benefit of the income exclusion.

Group-term life insurance

Under present law (sec. 79), the income exclusion for the cost of employer-provided group-term life insurance is subject to several limitations: (1) the exclusion is limited to the cost of the first $50,000 of such insurance on the employee's life, computed pursuant to tables prescribed by the Treasury Department; (2) no exclusion is provided for any "key employee" (officers, five-percent owners, one-percent owners with compensation in excess of $150,000, and certain employee-owners) if the program discriminates in favor of key employees as to either eligibility to participate or the life insurance benefits actually provided under the plan; and (3) no exclusion is provided for self-employed individuals (sole proprietors or partners).

The cost of group-term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost of $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. Under prior law, this rule did not apply to former employees who separated from service on account of retirement or disability. An employer could provide group-term life insurance for these two groups of former employees in amounts greater than $50,000 without any portion of the costs being included in their gross income.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is not available. In that event, the full cost of the group-term life insurance for any key employee is included in the gross income of the employee (based on the uniform cost table). In the case of benefits provided to retired or disabled employees, ~~prior law~~ did not require that the benefits be provided in a nondiscriminatory manner.

The Tax Reform Act of 1984 effects three changes in the present-law treatment of group-term life insurance. First, the $50,000 limitation on the amount of group-term life insurance that may be provided tax-free to employees also will apply to retired and disabled as well as active employees. Second, the nondiscrimination rules will be applied to plans covering retired employees. Third, under the Act, if a plan fails to qualify for the exclusion because it is discriminatory, then the employees and retirees will have to include in income the actual cost of their insurance benefit rather than the uniform table cost prescribed by the Treasury.

The provisions of the Act are applicable to taxable years beginning after December 31, 1983.[1]

Death benefits

Present law generally excludes from a beneficiary's gross income certain benefits paid by or on behalf of an employer by reason of an employee's death (sec. 101(b)). This exclusion is subject to several limitations: (1) only the first $5,000 of benefits attributable to any one employee is eligible for the exclusion; (2) amounts which are income in respect of a decedent (e.g., uncollected salary or unused vacation pay) are not eligible for the exclusion; (3) no exclusion is provided for amounts with respect to which the employee had a nonforfeitable right to receive the benefits, unless the source of payment is a qualified pension profit-sharing, or stock bonus plan or certain annuity plans; and (4) no exclusion is provided for amounts received under certain joint and survivor annuities where distribution to the participant had commenced prior to death. This exclusion generally is not available to self-employed individuals (sole proprietors or partners).

Accident and health benefits

Under present law, an employer's contributions to a plan providing accident or health benefits are excludable from the employee's income (sec. 106). No similar exclusion is provided for self-employed individuals (sole proprietors or partners).

Benefits actually paid under accident and health plans generally are includible in the employee's gross income to the extent attrib-

[1] The new provisions will not apply to any group-term life insurance plan in existence on January 1, 1984 (or to any comparable successor plan), but only with respect to those individuals who retire under the plan, who were employed during 1983 by the employer maintaining the plan, and who attained age 55 on or before January 1, 1984. The new provisions do not apply to any employees who retired before January 1, 1984. However, the nonapplication provision will not apply to any plan that is discriminatory after December 31, 1986, with respect to any individual retiring after that date.

utable to employer contributions (sec. 105(a)). However, payments unrelated to absence from work and reimbursements for costs incurred for medical expenses (within the meaning of sec. 213) are excluded from gross income (sec. 105(b)). In the case of self-insured medical reimbursement plans (sec. 105(h)), no exclusion is provided for benefits paid to any employee who is among the 5 highest-paid officers, a 10-percent shareholder, or among the 25-percent highest-paid employees if the program discriminates in favor of this group as to either eligibility to participate or the medical benefits actually provided under the plan.

Parsonage allowances

Present law permits a minister of the gospel to exclude from gross income the rental value of a home provided as part of compensation, or a rental allowance paid as compensation to the extent used to rent or provide a home (sec. 107). The exclusion is subject to several restrictions: (1) the amount of the exclusion is limited to the rental value of the home or actual amounts paid to rent or provide a home; (2) the exclusion is available only if the home or rental allowance is paid as remuneration for services; and (3) the exclusion for rental allowance is available only if the employer designates such payment as a rental allowance in advance of payment.[2]

Benefits provided to members of the Armed Forces

Present law permits military personnel to exclude a variety of in-kind benefits and cash payments from gross income. Specific exclusions apply to certain disability pensions (sec. 104(a)(4)); qualifying combat pay (sec. 112); mustering-out payments (sec. 113); and subsistence, housing, and uniform allowances, as well as the value of quarters or subsistence provided in kind (Regs. sec. 1.61-1(b)).

Meals and lodging for the employer's convenience

Present law excludes from gross income the value of certain meals or lodging furnished to an employee (or to the employee's spouse or dependents) by or on behalf of the employer for the convenience of the employer (sec. 119).

The exclusion for meals is available only if the meals are furnished (1) on the employer's business premises and (2) for the convenience of the employer. The latter requirement is deemed met where an employer furnishes meals without charge to an employee for a substantial noncompensatory business reason of the employer. The section 119 exclusion does not apply to employer-provided meals if the employee has the choice whether or not to purchase them (Regs. sec. 1.119-1(a)).

The exclusion for lodging is available only if (1) the lodging is furnished on the employer's business premises; (2) the lodging is

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[2] In 1983, the IRS ruled that ministers may not take deductions for mortgage interest and real estate taxes on their residence to the extent that such expenditures are allocable to tax-free housing allowances provided for ministers (Rev. Rul. 83-3, 1983-1 C.B. 72). The new deduction disallowance rule generally applied beginning July 1, 1983. Under a transitional rule, in the case of a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule generally will not apply until January 1, 1985 (IRS Ann. 83-100). The Tax Reform Act of 1984 extends this transitional rule date to January 1, 1986.

furnished for the convenience of the employer; and (3) the employee is required, as a condition of employment, to accept such lodging. Several court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution under the circumstances involved in those cases did not satisfy the section 119 requirements, and hence that the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes.[3]

Legal services

Present law excludes from gross income employer contributions to a qualified prepaid legal services plan, as well as the value of any legal services received by, or amounts paid as reimbursement for legal services for, the employee, or the employee's spouse or dependents (sec. 120). Also, the exclusion is available to self-employed individuals covered by qualified prepaid legal services plans.

This exclusion is subject to several limitations: (1) the program may provide only for personal (i.e., nonbusiness) legal services; (2) no exclusion is available if the program discriminates in favor of employees who are officers, shareholders, or highly compensated, as to either eligibility to participate or the benefits provided under the plan; and (3) no more than 25 percent of the employer contributions to the plan may be attributable to the group consisting of employees (and their spouses and dependents) who own more than five percent of the stock or of the capital or profits interest in the employer.

This exclusion is scheduled to terminate for taxable years ending after 1984.

Van pooling

Present law excludes from an employee's gross income the value of certain employer-provided transportation ("van pooling") between an employee's residence and place of employment (sec. 124).

This exclusion is subject to several limitations: (1) the exclusion is available only for transportation furnished through use of a commuter van; (2) no exclusion is provided if the van pooling arrangement discriminates in favor of employees who are officers, shareholders, or highly compensated; and (3) no exclusion is permitted for self-employed individuals (sole proprietors and partners).

The exclusion for van pooling is scheduled to terminate for van pooling provided in taxable years beginning after 1984.

Dependent care assistance

Present law excludes from an employee's gross income amounts paid or incurred by an employer for dependent care assistance provided under a qualified dependent care assistance program (sec. 129). Also, the exclusion is available to self-employed individuals (sole proprietors or partners).

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[3] The 1984 Act imposes a moratorium on the issuance of income tax regulations providing for the inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of the operating costs paid in furnishing the lodging or the rent received, applicable to qualified campus lodging furnished after December 31, 1983, and before January 1, 1986.

This exclusion is subject to several limitations: (1) the amount excluded may not exceed the employee's earned income (or, if the employee is married, the lower of the earned income of the employee or the employee's spouse); (2) the exclusion is only provided for expenses for household services or care of qualifying individuals (dependents under the age of 15 or physically or mentally incapacitated dependents or spouses) that are incurred to enable the taxpayer to be gainfully employed; (3) no exclusion is provided for amounts paid for qualifying services rendered by the employee's dependent or child of the employee who is under the age of 19; (4) no exclusion is provided if the dependent care assistance program discriminates in favor of employees who are officers, owners, or highly compensated individuals (or their dependents); and (5) no exclusion is provided if more than 25 percent of the total benefits paid are for the group consisting of employees who own more than 5 percent of the stock or of the capital or profits interest in the employer (or their spouses or dependents).

B. Miscellaneous Fringe Benefits

Background

A moratorium first enacted in 1978 prohibited issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits. The legislative moratorium expired on December 31, 1983. The Treasury Department has announced that Treasury and the IRS "will not issue any regulations or rulings altering the tax treatment of nonstatutory fringe benefits prior to January 1, 1985," and that "present administrative practice will not be changed during this period" (Ann. 84-5, 1984-4 I.R.B. 31).

General rule

The Tax Reform Act of 1984 provides a statutory exclusion from income and employment taxes for (1) no-additional-cost services; (2) qualified employee discounts; (3) working condition fringes; (4) de minimis fringes; and (5) qualified tuition reductions. Special rules apply with respect to certain free parking, susidized eating facilities, and on-premises athletic facilities provided to employees. No fringe benefit (other than a de minimis fringe) is excluded under the Act if another section of the Code provides rules for the tax treatment of that general type of benefit.

Under the Act, any fringe benefit that does not qualify for a statutory exclusion is expressly includible in gross income, and subject to employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit.

The rules of the Act do not make any change in existing statutory or regulatory exclusions for benefits for military personnel.

Exclusion provisions

No-additional-cost service.—A service provided to an employee is excluded if—

(1) the employer incurs no substantial cost (including foregone revenue) in providing the service;

(2) the service is provided by the employer or another business with whom the employer has a written reciprocal agreement,

and is of the same type ordinarily sold to the public in the line of business in which the employee works;

(3) the service is provided to a current or retired employee, or a spouse or dependent child of either, or a widow(er) or dependent children of a deceased employee; and

(4) for certain highly compensated employees, nondiscrimination requirements are met (see below).

Qualified employee discount.—A discount on merchandise provided to an employee is excluded to the extent it does not exceed the employer's gross profit percentage (in the relevant line of business). The exclusion does not apply to discounts on real property or on personal property of a kind commonly held for investment.

A discount on services provided to an employee is excluded to the extent it does not exceed 20 percent of the selling price of the services to nonemployee customers (with no gross profit percentage restriction).

The following conditions generally must be satisfied for the exclusion to apply:

(1) the property or service is provided by the employee and is of the same type ordinarily sold to the public in the line of business in which the employee works;

(2) the property or service is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee; and

(3) for certain highly compensated employees, nondiscrimination requirements are met (see below).

Working condition fringe.—Property or services provided to an employee are excluded to the extent that they would be deductible as ordinary and necessary business expenses (under Code secs. 162 or 167) if the employee had paid for them.

The Act excludes, as a working condition fringe, the value of free or reduced-cost parking provided to employees on or near the employer's business premises.

De minimis fringe.—Property or services not otherwise tax-free are excluded if their value is so small, taking into account the frequency with which similar fringe benefits (otherwise excludable as de minimis fringes) are provided and other relevant factors, as to make accounting for the benefits unreasonable or administratively impracticable. For example, benefits that generally are excluded as de minimis fringes include the typing of a personal letter by a company secretary, occasional personal use of the company copying machine, monthly transit passes provided at a discount not exceeding $15, occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare for employees because of overtime work, and certain holiday gifts of property with a low fair market value.

Subsidized eating facilities operated by the employer also are excluded as a de minimis fringe if located on or near the employer's business premises, if revenue equals or exceeds direct operating costs, and if (for certain highly compensated employees) nondiscrimination requirements are met (see below).

Athletic facilities.—An exclusion is allowed for the value of on-premises athletic facilities provided and operated by an employer for use of its employees. Under Code section 274, the employer is not allowed a deduction for the costs of an athletic facility if the facility is not primarily for the benefit of employees (other than employees who are officers, shareholders or other owners, or highly compensated employees).

Qualified tuition reduction.—The Act provides that a reduction in tuition provided to an employee of an educational institution is excluded for income and employment tax purposes if (1) the tuition is for education below the graduate level provided by the employer or by another educational institution; (2) the education is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee; and (3) certain nondiscrimination requirements are met (see below).

Nondiscrimination requirements.—The exclusions for no-additional-cost services, qualified employee discounts, subsidized eating facilities, and qualified tuition reductions are available to officers, owners, or highly compensated employees only if the property or service is provided on substantially the same terms to each member of a group of employees defined under a reasonable classification, set up by the employer, which does not discriminate in favor of officers, owners, or highly compensated employees.

Effective dates.—Under the Act, the provisions generally are effective beginning January 1, 1985. The provisions of the Act relating to qualified tuition reductions are effective for education furnished after June 30, 1985.

C. Tax Treatment of Benefits Provided Under a Cafeteria Plan

In General

Under a cafeteria plan, a participant is offered a choice between cash and certain fringe benefits. Under prior law, a participant in a cafeteria plan could choose among cash, taxable benefits (such as use of an employer-provided vacation facility), and nontaxable benefits (such as coverage under an accident and health plan). Present and prior law do not permit a cafeteria plan to offer either van pooling or any benefit that defers the receipt of compensation, with the exception of the opportunity for participants to make elective contributions under a qualified cash or deferred arrangement.

The mere availability of cash or taxable benefits under a cafeteria plan will not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes. Thus, a participant in a cafeteria plan is required to include in gross income only those taxable benefits actually received.

Under present and prior law a highly compensated participant, however, is treated as having received available cash and taxable benefits if the cafeteria plan discriminates in favor of highly compensated individuals as to eligibility or as to benefits or contributions. A highly compensated individual includes an officer, a 5-percent shareholder, a highly compensated individual, or a spouse or dependent of any of the preceding individuals.

The cafeteria plan rules generally do not affect whether any particular benefit offered under the plan is a taxable or nontaxable benefit. Thus, a benefit that is nontaxable under the Internal Revenue Code when offered separately is a nontaxable benefit under a cafeteria plan only if the rules providing for the exclusion of the benefit from gross income continue to be satisfied when the benefit is provided under the cafeteria plan.

IRS release, regulations

On February 10, 1984, the Internal Revenue Service issued a news release (IR-84-22), which stated that so-called "flexible spending arrangements" offered as part of cafeteria plans do not provide employees with nontaxable benefits under the Code because, under such arrangements, employees are assured of receiving the amounts available under the arrangement without regard to whether covered expenses are incurred.

In May 1984, the Internal Revenue Service issued proposed regulations with respect to the cafeteria plan rules and the statutory rules governing the exclusion of benefits from gross income. These proposed regulations state that an otherwise nontaxable benefit will be nontaxable if offered in a cafeteria plan only if it continues to satisfy the provisions governing exclusion of the benefit from gross income. Accordingly, the proposed regulations state that employer contributions with respect to an accident or health plan, a qualified group legal services plan, or a dependent care assistance program are not excluded from a participant's gross income under the Internal Revenue Code to the extent that the participant is assured of receiving benefits under the plan without regard to whether the participant incurs covered expenses.

Provisions of the Tax Reform Act of 1984

The Tax Reform Act of 1984 provides that, under a cafeteria plan, an employee generally can only choose between cash and those fringe benefits (other than scholarships or fellowships, van pooling, and those benefits excludable under the miscellaneous fringe benefit provisions of the 1984 act) that are excludable from gross income under a specific section of the Code.

Also, the Act amends the cafeteria plan rules to provide that if, for a plan year, more than 25 percent of the total nontaxable benefits are provided to employees who are key employees with respect to the plan for such year (as determined under the rules of sec. 416(i)(1)), such key employees will be taxed as though they received all available taxable benefits under the plan. Generally, in determining the portion of the total nontaxable benefits that is provided to key employees, coverage under a plan (e.g., an accident or health plan) and not actual expense reimbursements under such a plan are to be counted. The amendment does not alter the present law nondiscrimination rules relating to cafeteria plans.

Under the Act, certain employer reporting requirements are applied with respect to cafeteria plans. The Act provides both general and special transition relief, with respect to the proposed Treasury regulations on cafeteria plans, for cafeteria plans and "flexible spending arrangements" in existence on February 10, 1984. Finally, the Act provides that the Secretary of Health and Human Services, in cooperation with the Secretary of the Treasury, is to submit a report by April 1, 1985, to the House Committee on Ways and Means and the Senate Committee on Finance on the effect of cafeteria plans on the containment of health costs.

The cafeteria plan provisions of the Act are effective on January 1, 1985.

D. Welfare Benefit Plans

Deductions for contributions to funded benefit plans

The Tax Reform Act of 1984 modified the tax treatment to employers of welfare benefits provided to employees. Under the Act, deductions for contributions to a welfare benefit fund are limited to qualified costs, defined as the sum of (1) qualified direct costs, and (2) additions, within limits, to a qualified asset account.

Limitations on qualified asset account.—The Act provides rules relating to the limitation on additions to a qualified asset account. Such an account consists of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, and life insurance or death benefits.

In general, the account limit is the amount estimated to be necessary, under actuarial assumptions that are reasonable in the aggregate, to fund the liabilities of the plan for the amount of claims incurred but unpaid, for benefits described in the previous paragraph, and administrative costs of such benefits, as of the close of the taxable year. Claims are incurred only when an event entitling the employee to benefits, such as a medical expense, a separation, a disability, or a death actually occurs. The allowable reserve includes amounts for claims estimated to have been incurred but which have not yet been reported, as well as those claims which have been reported but have not yet been paid.

Child care facilities and other capital expenditures.—Under the Act, in determining qualified direct costs with respect to a child care facility held by a fund, the adjusted basis of the facility is treated as deductible ratably over a period of 60 months. Qualified direct costs with respect to other capital expenditures are those that would be allowed under the usual Code rules which would be applied if the employer owned the asset.

Prefunding of life insurance, death benefits, or medical benefits for retirees.—The qualified asset account limits allow amounts reasonably necessary to accumulate reserves under a welfare benefit plan for the medical benefit or life insurance (including death benefit) payable to a retired employee during retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of the employee, with the employer, subject to certain additional limitations.

Safe harbor.—The Act provides that an actuarial certification by a qualified actuary (determined under Treasury regulations) justifying the taxpayer's reserve computations is not necessary if the amount in the qualified asset account does not exceed a prescribed safe harbor, equal to the sum of separate safe-harbor amounts computed with respect to each benefit.

Certain collectively bargained plans.—By July 1, 1985, the Act provides that the Treasury Department is to publish final regulations establishing special reserve limit principles with respect to welfare benefit funds maintained pursuant to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence of good faith bargaining over the benefits provided by the plan between the employee representatives and the employer (or employers).

Transitional rule.—Under the Act, in the case of a plan that was in existence on June 22, 1984, special rules are provided for the determination of the limit for each of the first 4 years to which the provision applies.

10 or more employer plans.—For a plan year in which no employer (or employers related to an employer) is required to contribute more than 10 percent of the total contributions, the Act provides that the deduction limits do not apply.

Effective date.—These provisions generally apply to contributions paid or accrued after December 31, 1985. However, in the case of a plan maintained under a collective bargaining contract in effect on July 1, 1985, or ratified before that date, the provisions do not apply until the termination of the contract, determined without regard to any contract extension agreed to after that date.[4]

Excise taxes on funded benefit plans

Under the Act, an excise tax is imposed on the employer equal to 100 percent of any disqualified benefits provided by a fund under a welfare benefit plan.

The Act defines a disqualified benefit as (1) any medical benefit or life insurance benefit provided with respect to a key employee (sec. 416(i)) other than from a separate account established for that employee under the new rules relating to deductions under funded welfare benefit plans (sec. 419(A)(d)); (2) any medical or life insurance benefit provided with respect to a retired employee unless the benefit is provided from a fund that meets the additional requirements for tax-exempt status provided by the agreement (sec. 505(b)(1)); and (3) any portion of the fund reverting to the benefit of the employer.

These provisions generally apply to contributions paid or accrued after December 31, 1985. However, in the case of a plan maintained under a collective bargaining contract in effect on July 1, 1985, or ratified before that date, the provisions do not apply until the termination of the contract, determined without regard to any contract extension agreed to after that date.

Tax treatment of exempt benefit organizations

Unrelated business income.—Under the Act, the special rules applicable to voluntary employees' beneficiary associations (VEBAs) and social clubs for purposes of the tax on unrelated business taxable income are extended to supplemental unemployment compensation benefit trusts (SUBs) and group legal service organizations (GLSOs). In addition, more specific limits are provided with respect

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[4] In addition, the Act applies to any contribution of a facility to a welfare benefit fund after June 22, 1984, so that deductions with respect to this contribution are to be determined under usual Code rules applicable to recovery of the cost of assets (but taking account of the special rule for child care facilities described above). Further, these rules apply to other contributions, such as cash, made after that date which are to be used to acquire a facility, so that later acquisition of a facility with the use of such funds will limit the deduction for the original contribution. This rule does not apply for any facility acquired under a binding contract in effect on and at all times after that date, or any facility under construction on June 22, 1984.

to the amount that may be set aside for exempt purposes by such an organization.

The Act also provides for a tax on an employer who maintains a welfare benefit fund that is not exempt from income tax. Under the Act, in the case of any welfare benefit fund, such as a retired life reserve account, that is not exempt from income tax as a social club, VEBA, SUB, or GLSO, the employer who maintains the fund is to include in gross income for the taxable year an amount equal to the deemed unrelated income of the fund.

These provisions generally apply to contributions paid or accrued after December 31, 1985. However, in the case of a plan maintained under a collective bargaining contract in effect on July 1, 1985, or ratified before that date, the provisions do not apply until the termination of the contract, determined without regard to any contract extension agreed to after that date.

Discrimination.—The Act establishes new nondiscrimination standards for a tax-exempt VEBA or GLSO. With respect to the nondiscrimination rules, certain employees who are not covered by a plan may be excluded from consideration in applying the nondiscrimination standards. These employees are employees who have not attained the age of 21, employees who have not completed 3 years of service with the employer, less than half-time employees, employees who are included in certain collective bargaining units, and certain nonresident aliens.

These provisions apply to taxable years beginning after December 31, 198

III. BACKGROUND DATA RELATING TO TAX TREATMENT OF CERTAIN FRINGE BENEFITS

A. Revenue Implications

Table 1 below shows the estimated increases in revenues which would result from terminating the present-law exclusions for certain statutory fringe benefits described in Part II-A of this pamphlet.[5]

Each entry in the table has two lines. The first represents the estimated increase in income tax receipts which would result if the benefit were included in gross income. The second line shows the estimated increases in social security tax receipts which would result if the benefit were included in the FICA tax base.

In terms of revenue effect, health insurance is the largest fringe benefit shown in this table, followed by group term life insurance. Each of the other fringe benefits shown in this table has less revenue impact.

Table 1.—Effects of Including Certain Statutory Fringe Benefits in the Federal Income Tax Base and the FICA Tax Base

[In billions of dollars]

Item	1984	1985	1986	1987	1988	1989
1. Employer contributions for health insurance:						
Income tax	17.6	20.2	23.0	26.2	29.9	34.1
FICA	6.7	7.7	8.8	10.1	11.9	13.7
2. Premiums on group term life insurance:						
Income tax	2.2	2.4	2.6	2.9	3.2	3.6
FICA	.5	.8	.9	.9	1.0	1.1
3. Contributions to prepaid legal services plans:						
Income tax	(1)	(1)				
FICA	(1)	(1)				
4. Employer educational assistance:						
Income tax	(1)					
FICA	(1)					

[5] This pamphlet does not describe the statutory exclusion for employer contributions to qualified pension, profit-sharing or stock bonus plans, qualified annuity plans, or tax-sheltered annuity plans.

Table 1.—Effects of Including Certain Statutory Fringe Benefits in the Federal Income Tax Base and the FICA Tax Base—Continued

[In billions of dollars]

Item	1984	1985	1986	1987	1988	1989
5. Employer provided child care:						
Income tax	(1)	.1	.1	.1	.2	.2
FICA	(1)	(1)	(1)	(1)	.1	.1
6. Employee meals and lodging (other than military):						
Income tax	.7	.8	.9	.9	1.0	1.1
FICA	.2	.2	.3	.3	.3	.3
7. Benefits and allowances to Armed Forces personnel:						
Income tax	1.9	2.0	2.2	2.3	2.4	2.6
FICA	(2)	(2)	(2)	(2)	(2)	(2)

(1) Less than $50 million.
(2) Not available.

B. Growth in Fringe Benefits

Tables 2 and 3 present data from the national income accounts on the growth between 1950 and 1981 of employer contributions to group health insurance and group life insurance, the two largest generally available statutory fringe benefits which are shown in Table 1, measured in terms of revenue effect.

Table 2 shows that during this period, these two benefits grew considerably faster than wage and salaries. Group health insurance grew from 0.5 percent of wages in 1950 to 3.8 percent of wages in 1981, and group life insurance contributions increased from 0.2 percent of wages in 1950 to 0.4 percent of wages in 1981.

Group health insurance has grown at a much faster rate than group life insurance. Group health insurance has continued to grow throughout the period, while group life has been approximately the same percentage of wages since 1965. Although many factors have influenced the growth of these two fringe benefits, it should be noted that the tax treatment of group term life insurance changed in 1964, when a limit was placed on the amount of employer contribution which could be excluded from gross income for income tax purposes.

Table 3 shows another way of examining the growth in employer contributions to health and life insurance during this period. These figures compare the increase in wages to the increase in the fringe benefit during this period.

Between 1950 and 1955, for example, health contributions increased 1.5 cents for every dollar of increase in aggregate wages. By the end of the period, health benefit contributions increased approximately 5.5 cents for each dollar of increase in wages. Thus, there was a significant acceleration in the growth of health benefits relative to wages over the 1950 to 1981 period, although this trend stabilized during the 1970's.

In contrast, increases in group term life insurance as percentage of wage increases declined over the 1950-1981 period. During the first five years, group term life insurance contributions increased 0.5 cents for every dollar of wage increase. This figure reached a peak during the last part of the 1950's. Since that time, however, the increase in life insurance as a percentage of wage increases declined significantly, so that by 1981 these contributions increased by only 0.3 cents for every dollar of wage increases.

Table 2.—Employer Contributions to Group Health and Life Insurance as Percentage of Wages and Salaries, United States, 1950-81

[In percent]

	Group health	Group life
1950	0.5	0.2
1955	.8	.3
1960	1.3	.4
1965	1.6	.5
1970	2.2	.5
1975	3.0	.5
1980	3.7	.5
1981	3.8	.4

Source: Computed from U.S. Department of Commerce data.

Table 3.—Increase in Total Employer Insurance Contributions as Percentage of Total Increase in Wages, United States, 1950-81

[In percent]

	Group health	Group life
1950-55	1.5	0.5
1955-60	2.8	.9
1960-65	2.7	.6
1965-70	3.3	.7
1970-75	4.7	.6
1975-80	4.5	.3
1980-81	5.5	.3

Source: Computed from U.S. Department of Commerce data.

Statement of Senator Dole, Finance Subcommittee on Taxation and Debt Management

Mr. Chairman, I would like to thank you for holding these hearings on this important issue. This hearing will provide us the opportunity to review the specific exclusions from taxable compensation that have developed over the years.

DEFINITION OF GROSS INCOME

The code defines gross income for income tax purposes as including "all income from whatever source derived" and specifies that it includes compensation for services. The definition of gross income includes both legal and illegal income. Similarly, the social security and unemployment insurance payroll taxes (FICA and FUTA) and income tax withholding generally apply to all remuneration for employment, including noncash remuneration.

DEVELOPMENT OF SPECIFIC EXCLUSIONS

Over the years, we have enacted a number of specific exclusions from the broad definition of gross income contained in the Internal Revenue Code. The exclusions were intended to achieve social and economic goals which were considered desirable at the time of enactment. For instance, the exclusion from an employee's gross income for employer-provided health care coverage was intended to encourage employers to provide comprehensive medical coverage for all workers. Certainly this desirable social goal has been achieved through the use of tax incentives.

Congress has provided specific exclusions from gross income for employer-provided benefits of: (1) the cost of up to $50,000 of group life insurance; (2) up to $5,000 of death benefits; (3) accident and health benefits; (4) parsonage allowances; (5) certain benefits provided to members of the armed services; (6) meals and lodging for the convenience of the employer; (7) legal services; (8) commuting through the use of a van pool; and (9) dependent care assistance.

MISCELLANEOUS FRINGE BENEFITS

Since 1978, Congress has been struggling with the issue of nonstatutory fringe benefits. For the first time in the history of the Internal Revenue Code, the Deficit Reduction Act of 1984, contains specific rules providing employers with guidance on the kind of employer-provided goods and services that are excludable from an employee's gross income. This legislation is probably the most significant fringe benefit legislation enacted in recent times and provides employers with specific guidance on how to pay employees with nontaxable compensation. This legislation will affect every employer, and will have a direct impact on future compensation planning and employer competition.

Most of the specific gross income exclusion developed independently of each other and generally were enacted for very worthwhile causes. These hearings will provide us with an opportunity to review all of the income tax exclusions that we have granted various employer-provided services over the years and develop a consistent policy on the tax treatment of these benefits. These hearings will also provide an opportunity to receive testimony on which employer-provided tax benefits are cost effective in obtaining the desired social and economic policies intended by Congress.

Hopefully, these hearings will also provide us with useful data on which employees are benefiting from the various tax-free benefits that Congress has enacted. One of the significant problems we face when looking at existing tax-free benefits is determining how much they cost the government. I hope that employers and trade groups will use this opportunity to provide us with specific data on the number and income range of the various employees who benefit from these services. In addition, I hope that employers and trade groups would be able to provide us with data of the most cost effective means of providing these benefits to all workers.

FISCAL AUSTERITY

During the last few years, many of us have had occasion to use the term "fiscal austerity" when talking about the various direct spending programs of the government. This hearing provides us with a unique opportunity to subject the various tax benefit programs to the same scrutiny that we give to direct government spending programs. As we are looking at ways to curb the growth of various spending programs, we must use the same guidelines to review indirect spending programs such as tax benefits for similar groups.

We must also assure ourselves that the nondiscrimination rules and other conditions that we place on these tax benefits effectuate our objective of ensuring that the tax benefits are available to lower paid employees on the same terms and conditions that they are available to highly compensated employees and owners and shareholders of the company. Unlike direct spending programs, tax benefits are much more difficult to target for the intended beneficiaries. Once the tax benefits are given, there are very few assurances that the eventual beneficiaries of the tax benefit will be the ones intended by Congress.

IMPACT ON THE TAX BASE

At this point, I would like to include in the record an editorial from the July 23rd Washington Post. The essence of the editorial is that once Congress enacts a tax benefit, such as a specific exclusion from gross income, a constituency develops that has a vested interest in the continuation of the tax benefit. This constituency makes it much more difficult for Congress to terminate the tax benefit even if the social purpose of the tax benefit is not achieved or the tax benefit ends up being overly generous. In addition, the article concludes, that regardless of the terms and conditions that we may impose on various tax benefits, the highly compensated employees may be receiving most of the benefits.

We must also realize that tax-free fringe benefits have been growing at a much faster rate than taxable wages. According to U.S. Department of Commerce data, in 1950, employer contributions to group health plans represented one-half of one percent of wages and salaries. In 1981, employer contributions to group health plans represented 3.7 percent of wages and salaries. Fringe benefits now count for approximately 16 percent of all compensation and nonstatutory fringe benefit legislation in the Deficit Reduction Act of 1984 will undoubtedly accelerate this growth. Hopefully, the witnesses at this hearing can also provide us with accurate data on the growth of taxable and nontaxable compensation. Except for benefits such as health plans and life insurance, there is very little information on the nontaxable compensation.

CONCLUSION

During the Social Security debates of last year, some actuaries estimated that, if the fringe benefit growth could be arrested, a major part of the uncertainty surrounding the long-range solvency of the Social Security System could be removed. As we review the testimony presented at these hearings, we must all remember that to the extent narrowing the tax base causes pressure to increase marginal tax rates, these tax-free benefits will only appear to be free, because ultimately every taxpayer will have to pay for them in the form of higher taxes on the portion of his compensation that is subject to taxes.

[From the Washington Post, Monday, July 23, 1984]

FRAYED AT THE FRINGES

One big reason that tax rates—both income and payroll—are so high is that less and less income is being taxed at all. This fraying of the tax base is partly due to the constant accumulation of deductions, credits and preferences added to the code at the behest of this or that lobby. But a major source of erosion is the fact that people are increasingly taking their income in the form of nontaxable fringe benefit rather than taxable wages.

The tax bill signed into law recently by President Reagan puts some very modest curbs on the proliferation of fringe benefits. Since every tax loophole quickly creates a lobby with a vested interest, even these timid reforms have drawn shrieks of protest. The education and training lobby is upset, for example, because companies will again have to limit tax-free tuition payments for workers to job-related courses.

Providers of education and training protest that the limit discourages learning and skill development, surely things to be encouraged. Similar arguments will be made by providers of health, life and disability insurance, child care, dentistry, eyeglasses, exercise classes, legal advice and consciousness-raising instruction. All these things can be useful and enjoyable. But why should some people be able to buy them with before-tax dollars while others cannot?

The introduction of "cafeteria plans," which allow workers to tailor fringe benefits to their needs, removes a major barrier to the growth of fringe benefits. When beenfits were limited to items such as health insurance, the need for which cannot be predicted with great accuracy, employees were releuctant to convert too much of their cash wages into untaxed frignes. But flexible plans allow employees who know, for example, that they will need to purchase thousands of dollars of child care or legal services, to opt for those benefits and avoid taxation.

Fringe benefits have been growing much faster than wages. They now account for 16 percent of all compensation. Without further tightening of the tax law, that growth is likely to accelerate. This is unfair, since it is the better-paid workers who typically get the most fringe benefits. It is also a major threat to both the Social Security system and the general treasury. Actuaries estimate, for example, that if frienge benefit growth could be arrested, a major part of the uncertainty surrounding the long-range solvency of Social Security would be removed.

Remember that fringe benefits only look free. Ultimately you—and every other taxpayer—will pay for them in higher taxes on the rest of your income and less control over how you spendor save the money you earn.

STATEMENT OF SENATOR JOHN H. CHAFEE

Senator Packwood should be commended for holding hearings on this very important issue. During the debate on the recent tax bill, "The Deficit Reduction Act of 1984," some of the most hotly contested items were in the area of "fringe benefits." The length of the witness list for the hearings today, tomorrow, and Monday is another indication of the importance of this issue, and I look forward to hearing what all these very interested parties have to say.

The title of these hearings may be a little misleading. "Fringe" benefits somehow suggests that these items are superfluous extras, and perhaps of little consequences to most employees. I think the accumulated testimony over the next few days will reveal that these benefits are very important to large numbers of employees, and that they are very expensive employee benefits. The term "employee benefits" rather than "fringe benefits" would perhaps be a better term to use to describe what most of the witnesses are here to discuss.

These hearings are supposed to be examining what some refer to as the "consumable" employee benefits, as opposed to "deferred" employee benefits, such as pension plans. Since I chair the Finance Subcommittee on Savings, Pensions and Investment Policy, I have a strong interest in deferred employee benefits. There are numerous questions that need to be asked and answered in separate hearings in that Subcommittee on Pension Policy. In looking over some of the testimony for today's hearing I notice that many of the witnesses have taken the opportunity to mix into their discussion of "fringe" benefits, questions of pension policy that will have to be addressed more in depth at subsequent hearings.

Pension benefits in many ways overshadow all other employee benefits because of their tremendous cost. Each year the President in his proposed budget must submit to the Congress an estimate of how much every tax "incentive" or tax "break" in the code costs the Federal Government. He must list each tax "expenditure" and estimate the cost of it, just as if it were a direct spending program. The tax "expenditure" for pensions (employer plans, IRAs, and KEOGHs) is the largest category of tax expenditure in the code. For 1983, the cost of employer plans was listed at $56.9 billion.

I think that we should hold separate hearings on this one category of employee benefits to determine whether the tax incentives for pension plans are working as intended. Specifically, we should look at whether all the items listed and justified as "deferred" benefits are actually being used for retirement or pension security, or whether they are being used more as currently consumable employee benefits. Are IRA's and 401(k) plans really being used for retirement purposes or just for tax deferred savings? We should also look at some of the same questions Senator Packwood has raised about the distribution of pension benefits. For example, which income classes would really benefit from increasing spousal IRAs?

Addressing the questions Senator Packwood has raised in the press release for these hearings on consumable employee benefits will be quite a challenge in the next few days. Complicating the discussion by trying to answer other questions regarding pension plans should not distract us since there will be future hearings on the pension issues.

Following my own advice, I would now like to turn to the subject of tax incentives for "fringe benefits." The Deficit Reduction Act of 1984 contains a long awaited clarification of the taxation of employee benefits. The Act attempts to codify many of the current practices which have arisen in certain industries to provide "tax free" benefits to employees. We have protected many of the tax free benefits such as employee discounts for retail store employees, airline passes for airline employees, and tuition remission for university employees. Viewed strictly from the tax policy standpoint, there are some intellectual inconsistencies in what we have done, but we have at least provided clarity so that from now on everyone should know which benefits are taxable and which are not.

Having drawn the rules to clarify which employee benefits are taxable and which are not, we still have quite a job ahead of us. As I said earlier, the number of witnesses at these hearings is indicative of the popularity and growth of employee benefits as an expected part of any employee compensation package.

What we as policymakers have to do is find the proper balance in the taxation of these benefits. I am delighted that most employers are routinely providing health insurance to their employees. I know that the tax free nature of this benefit has contributed to this practice.

The tax expenditure for employer provided health insurance is the fourth largest tax expenditure listed in the President's budget request. For 1983 this tax expenditure was listed at $15.2 billion. The tax expenditure for employer provided life insurance was $2 billion. Employer provided child care, prepaid legal services and educational assistance were smaller—$20 to $40 million each.

I think we must look at these items just as we look at direct spending programs in the budget and see who is benefiting and whether we think we are getting our money's worth. I am not prepared to continue to expand this list of tax free benefits to auto insurance, homeowner's insurance and the like, although there is probably someone out there who will make the argument that employers should be encouraged to provide all these benefits as well.

Next year the Congress may be considering serious tax reform, and several of the current proposals, such as the Bradley-Gephardt "Fair Tax" bill propose to tax all employee benefits. I am not certain that all of the people currently advocating a "flat tax" or "modified flat tax" realize that taxation of currently tax free employee benefits would be part of that proposal.

While I am not advocating taxation of all the currently tax free benefits, I do think we ought to seriously consider some sort of overall cap, either based on a percentage of compensation or simply a dollar amount. If we do not place some limitation on the amount of non-cash compensation that can be given tax free, we are going to see a continued erosion of our tax base, both for income tax purposes and for purposes of the social security tax base. Furthermore, the growing inequities among employees who work for companies that provide huge amounts of tax free benefits and those employees who have to purchase these increasingly expensive items on an after tax basis will grow. We will be increasing the tax burden on the unlucky wage earner who receives his compensation in cash, while some workers receiving the same cash wages will be enjoying unlimited nontaxable noncash benefits.

There are other issues which I hope the witnesses at this hearing will address. I have serious questions about whether the provision of first dollar coverage under employer provided health insurance plans is contributing much to our efforts to contain the rising cost of health care. I have serious questions about some of the cafeteria plans that some partners in law firms are using to pay $25,000 a year pre-tax to pay for a live-in nanny for their children, while employees in my office have to pay after tax dollars for whatever childcare they can afford. True, my employees can claim up to $1,440 per year as a tax credit for child care expenses, but even for employees in the 50 percent bracket, this amounts to a comparable exclusion of only $2,880 per year.

This is not to say that I want to tax the health insurance coverge or end cafeteria plans and employer provided day care. What we are going to have to do in this area is find some balance between sound tax policy and good social policy. We certainly want to continue to encourage employers to provide health insurance for their employees, to continue the flexibility of cafeteria plans, and continue to assist families with child care. But, some limitations on tax free employee benefits are going to be necessary if we want to preserve the tax base and assure the equitable taxation of all employees receiving the same compensation, whether in cash or "fringes."

Senator PACKWOOD. The hearings will please come to order. Let me first express my thanks to all of the witnesses who have indicated they wished to participate, as well as to the Treasury Department.

We have had more of an outpouring of requests to testify than I ever imagined. Almost all of it is from people with a perfectly justifiable reason to testify. We had 110 requests for appearances, many people representing individual companies, many of them large, with thousands of employees covered by benefits.

We clearly could not accommodate 110 witnesses in 3 days, being interrupted as I fear by votes from time to time. So, we cut it down somewhat, and all the witnesses are aware of the time constraints that they are going to have to operate under—3 minutes, 4 minutes, and in some cases, 5 minutes, the length varying depending upon the number of people in the panel.

I will be adhering to those times limits very closely. The purpose of the hearings, as far as I am concerned, is to lay the groundwork against what I think is going to be a future attack on employee benefits. I am not quite sure what motivates the attack although I was struck by one of the things that I found in Peter Biggins statement. He represents LTV, he said, and I quote, "there was a time when compensation was perfectly flexible. Salary was the only source of compensation. The employees had complete freedom to use it as he or she wished. Both the employer and the employee got full value from compensation."

I recall a long series of discussions I used to have with my then, and still, close friend Jim Lynn, the former Director of the Office of Management and Budget, and HUD Secretary. He felt that there should be no employee benefits, that all compensation should be in the form of wages. The taxes would be levied upon it, and then the employee could use it for anything they wanted, whether it was pensions or health, et cetera.

That is a perfectly legitimate philosophy. It is not one with which I agree but I understand the philosophy. Some people who want to fully tax employee benefits I think are motivated by the desire to get rid of employer provided benefit plans. Whether they are fully employer paid, partially employer paid, or otherwise, and would go to a strict market economy. The employees would be paid whatever their negotiated full value is worth. They would purchase whatever benefits they want on their own, or if they can form some kind of a group, they will do so.

I don't find that philosophy publicly stated very often. I have a feeling that at least privately, it motivates some of the opposition to employee benefits, or at least to nontaxed employee benefits.

There is another strain that wants to tax them simply because we need revenue to reduce the budget deficit. That is a fully understandable reason. I have been on this committee long enough to see what happens when we get into a bind and we have to have money. We go into one of those closed sessions and we start going down a list of items. At the right hand end of each item is an estimate of how much revenue it will produce if we close the loophole or adopt whatever measures we are considering. If we are looking for a fixed amount of money, we start going down the column until we come to that amount, without much merit in terms of deciding what we are going to pick.

It has been my experience that in those closed sessions, if there is some member that is adamantly opposed to something on the list and will fight it, it will probably get dropped from the list. What remains are those things that don't have any extraordinary defenders on the committee, and that becomes the tax bill.

As I say, in many cases it isn't with or without merit so much as the fact that it doesn't have a defender. I see Senator Chafee has joined us. He and I have shared the same view for years on the need for revenue, and that is one way we get it.

But I think the real issue that I hope these hearings accomplish is the taxation of employee benefits. I hope the argument will not be—are the people of this country going to have benefits. Are they going to have no insurance? Are they going to be adequately covered with health protection, with day care protection, with pension protection? I would hope that battle is over, and that we realize one way or the other that people are going to be provided with at least the basic necessities that most of us would consider requisites to a decent life. Those requisites are either going to be provided by governments or they are going to be provided by employers. With most of our major trading competitors in Europe, those benefits are provided by the government, who of course levies a tax on everyone to pay for them. In Japan, they are more commonly provided by employers. Japan has a much higher ratio of employee benefits to wage than the United States does, and the United States has a slightly higher one than does most of Western Europe. Things that we would provide here through employer plans are provided there quite often through the government.

It seems anomalous to me if we say that people are going to be covered with adequate health insurance or day care or whatever it is, if the Government provides it, then there would be no tax levied on the employee, but if the business provides it, there will be a tax levied.

If the goal is to provide adequate benefits, then I run across people, except genuine socialists, who would argue that the Government can provide the benefits better than business, if they are going to be provided.

Second, it has been my great experience in dealing with unions that they do know their members well. I was a labor relations lawyer for 5 years and negotiated with most of the unions that are in existence today at one time or another. They really have to take care of their members reasonably well. The demographics of different unions are amazingly different. The employee benefits that may be needed for one type of industry turn out not to be the employee benefits that are needed for a different kind of industry, simply because of the age and makeup of the work force. In some cases the sexual orientation of the work force determines what employee benefits are offered, depending upon whether it's more heavily male or heavily female. When government provides benefits, however, they are the same whether they are provided in Newport, Oregon, or in New York City. It doesn't matter that New York City and Newport may have slightly different needs or interests or age groups or demographics or anything else. It is a government benefit, and it is the same throughout the country.

I have read all of the statements that have been submitted to date. They are a cornucopia of information. Over and over and over, they make the point, without exception, that none of the employers, none of the unions are asking for discriminatory benefits. The unions and employers want to make sure that their members and employees are taken care of on the broadest possible basis without discrimination. I would hope that we are not going to raise the argument against employee benefits that they have been abused in the past by small private corporations who have managed to legally twist the tax laws to their benefits.

That twisting is wrong. We do the best we can to correct it, and to that extent I take my hat off to Mr. Chapoton, with whom I have worked closely on this issue. We are normally on different sides, but we both agree that we want to end those flagrant discriminatory abuses that serve no useful purpose. That is a black mark against all of us who are in favor of these benefits.

I hope when we are done with these hearings that we will have a full record of the panoply of benefits that are legitimately provided by legitimate employers or bargained for by the legitimate unions in this country. Then we can make a decision (1) are the kinds of benefits provided legitimate? If so, (2) are they better provided by the Government or by business? They are going to be provided, and if they are not provided by business, the clamor to have Government provide them will succeed. (3), if they are going to be provided and if we conclude that it is better they be provided by business, should we have a tax code that encourages the provision of those benefits? Should we have a tax code that discourages the provision of those benefits, knowing full well what the ultimate consequences would be, Government provision of the benefits. John?

Senator CHAFEE. Thank you very much, Mr. Chairman. I am glad you are going to hold these hearings. As you know, you and I have differed to some degree in our approach to this subject. I think you make a good point when you speak of those benefits which people would look to the Government to provide. It is better to have the private industries provide those benefits, and this is happening with so many industries today. Of course, the benefits must be provided on a nondiscriminatory basis. However, when industries move into a whole series of areas that I don't think any of us think it is a legitimate Government function to provide, such as auto insurance, auto repairs, perhaps home owners insurance, and matters like that, then we are faced with a different situation. Some have said that there should be no restrictions on these benefits. They argue that the employers in their own best interests will not go further than they should go in providing tax free benefits because of the expense to the employers.

I don't think it has always worked out that way. I am not sure that the Federal Government would necessarily provide airplane rides for a stewardess' parent if the employer didn't provide it. So, it is a very important area to look at these distinctions. It is costing the Federal Government a lot of money. I know some would object to that phrasing. I wish I had a more delicate way of phrasing it because I don't think the Federal Government is entitled to everybody's money. However, I do think that the current growth of tax expenditures in the employee benefit area should be carefully looked at.

So, Mr. Chairman, I've got a lengthy statement here I would ask be included in the record, and I look forward to these hearings. Unfortunately, the Secretary of State is having a briefing at 10.

Senator PACKWOOD. I actually asked him to call that because I knew you would probably want to go to it and couldn't stay for the hearing. [Laughter.]

Senator CHAFEE. Well, I thought there might be some malice of forethought, but I think I will do something unique. I will read everything, as long as the statements aren't too long. Thank you.

Senator PACKWOOD. Thank you very much.

Senator CHAFEE. Is our first witness Mr. Chapoton?

Senator PACKWOOD. Yes. Our first witness is the Assistant Secretary.

Senator CHAFEE. Not only is he our first witness, but I think it is the last time we will see him as a witness. Is that right?

Mr. CHAPOTON. That is right, Senator.

Senator PACKWOOD. Is it true that you said no more mister nice guy when you wrote this statement? [Laughter.]

Senator CHAFEE. I am sure you have got a statement about Mr. Chapoton, but we will all miss him. He has done a superb job over the last 3½ years. I marvel at how he manages to retain so much information on so many diverse topics, convey it all in a lucid manner, and through it all keeps his sense of humor.

You have really done a superb job and we are grateful for all the assistance you have given us on this committee.

Mr. CHAPOTON. Thank you, Senator Chafee. I have enjoyed it very much.

Senator PACKWOOD. Buck, I have got to second that. I don't know how you have managed over these years to keep your composure, your sense of humor and your intelligence intact. I have watched you go through those 13-, 14-, 15-hour sessions, as each one of us takes a little nip of you. You respond, and when we've have had our nip, we go off and have dinner or something. Then the next person takes a shot, and you sit there with extraordinary patience while making decisions involving billions of dollars.

You speak for the administration, without ever having, in most cases, been able to talk with anybody about most of the things we bring up. You do it with marvelous aplomb and intelligence, and I cannot tell you personally—despite the fact we disagree on this subject—how much I have enjoyed working with you and how very, very much I will miss your presence.

Mr. CHAPOTON. Thank you, Senator Packwood. It would be unfair for me to take all the credit. I have a tremendous staff and a tremendous committee staff that gives us help all the time. It is not difficult when you have that much help, I assure you. I sure appreciate, more than I can say, the cooperation I have had from all the members of the committee, as a group and individually. It has been a tremendous pleasure for me throughout.

Senator PACKWOOD. I would like to say to the other witnesses that we do not enforced the 3-minute rule on the Secretary. I have tried on occasion, but it has never worked. [Laughter.]

Senator PACKWOOD. For all other witnesses, we will adhere to a very tight rule. All of your statements will be included in the record. If you all speak to us as if you were speaking in the living room rather than as a witness, we would appreciate it. Buck, go ahead.

STATEMENT OF THE HONORABLE JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Mr. Chairman, I thank you, and I will attempt to be brief, to summarize my statement.

I would like to start off by joining Senator Chafee in congratulating you for holding these hearings. As you point out, we have disagreed on certain aspects of this subject—not all aspects—but it is a very important subject, and I think these hearings—and the turnout you have had for these hearings—certainly indicates the importance of it.

So, I am pleased to present the Treasury Department's views on this subject. In the just passed legislation, as you know, Mr. Chairman, there were some significant changes in the rules governing fringe benefits, including I would mention particularly the application of deduction and other limits to VEBA's and other welfare benefit plans, and then the very important codification of the tax-free nature of certain formerly nonstatutory fringe benefits, such as employee discounts and free parking—that sort of thing.

We think the Deficit Reduction Act was an appropriate step in rationalizing the Federal tax treatment of fringe benefits, needed clarification was provided to individual taxpayers and to employers, and progress was made in limiting the expansion of fringe benefits.

My statement today outlines the areas we see that we continue to be concerned about in the employee fringe benefit area. I am going to focus particularly on the statutory fringe benefits—those that are exempted from tax under specific provisions of the Tax Law, and I am going to discuss in particular the growth in fringe benefits provided under employee-sponsored welfare benefit plans.

At the outset, let me mention that we are concerned that the expansion of fringe benefits excluded from the Federal income tax and Social Security tax bases has caused Federal tax rates—both Social Security and individual tax rates—to be higher than they would otherwise have to be. I would simply point out that the success we have had in recent years in holding and cutting back in the growth of marginal tax rates could be undermined quickly by any significant narrowing of the range of compensation subject to tax.

We are also concerned that the tax benefits derived from the existing statutory benefits may not fairly be distributed among taxpayers. And, finally, we are concerned that in some instances the exclusions from gross income of certain benefits fail to promote policies underlying the favorable treatment.

First, let me deal with the impact on the income of the Social Security tax base. Generally, as we know, an employee is required to include gross income for both Federal income tax and Social Security tax purposes—all compensation in whatever form paid, whether cash or in the form of other other benefits, but benefits provided under certain employer sponsored plans that satisfy applicable Code provisions are excluded from both the income and Social Security tax bases.

Generally, the benefits qualify for exclusion only if the plan satisfies eligibility coverage and nondiscrimination rules designed to assure that the benefit is provided to a broad cross-section of the employees on a nondiscriminatory basis. Prior to the enactment of ERISA in 1974, the major statutory fringe benefits were qualified pension and profit-sharing plans, group term life, and medical benefits. These benefits were designed to encourage employers to provide these types of benefits that would protect employee and their families from hardship on account of separation from service, death, and sickness or disability. Beginning with ERISA, however, statutory exclusion of fringe benefits from taxation has grown to include employee stock ownership plans, group legal services, van pooling, educational systems programs, and dependent care programs. The expansion of the statutory nontaxable benefits has the effect of reducing the cost of a broad range of goods or services that are purchased by a wide sector of the population.

Predictably, this has put pressure on employers to provide increasing portions of compensation in nontaxable forms. Various surveys based primarily on Department of Commerce and U.S. Chamber of Commerce data reveal that the percentage of total compensation that is paid in the form of agreed-upon fringe benefits, such as qualified plans and employer-provided health, as distinguished from the required benefits, such as employee compensation and unemployment compensation and worker compensation, has consistently increased over the last 25 years. One survey indicates that the percentage of total compensation paid in the form of agreed-upon benefits that are excluded from tax has grown from 2.6 percent in 1950 to almost 10 percent in 1983. The growth in tax favored benefits——

Senator CHAFEE. Could I just ask a question, Mr. Chairman?

Senator PACKWOOD. Sure.

Senator CHAFEE. Mr. Chapoton, I am surprised that it is not even more than that. I thought these fringe benefits in some instances would amount to 26 to 33 percent. Isn't that what they compute for a Government employee? Something very substantial like that?

Mr. CHAPOTON. This does not include legally required benefits, such as unemployment compensation. These are, in effect, voluntary, agreed-upon forms of fringe benefits, such as retirement benefits, such as health, and now such as legal benefits, which the employer can or cannot negotiate.

Senator CHAFEE. But you take the auto workers, for example, they will say that they are receiving $13.00 an hour, but with fringes it is $22.00 an hour. In other words, nearly double or 80 percent of their wages.

Mr. CHAPOTON. Sure. For example, they negotiate extremely high health care or health insurance packages.

Senator CHAFEE. So, these statistics are national statistics, are they?

Mr. CHAPOTON. These are national statistics. That is right. And we are covering only statutory exclusions. We are not covering parking and things such as that, but in all candor, I think in dollar terms, in percentages, those do not add up to—They would increase these figures if you put them in, but they would not dramatically increase them.

The growth in these benefits has been stimulated by the statutory authorization of cafeteria plans. As we discussed last year before this committee at some length—or before the Congress at some length—cafeteria plans permit individuals—basically individual employees—to pick and choose which benefits they will receive. The flexibility inherent in cafeteria plans substantially eliminates the presence of employee jealousy in the restraint of the amount of compensation provided in tax-favored forms. The desirability of a particular benefit—a particular fringe benefit—differs of course from employee to employee, and fringe benefit compensation is generally sought by some employees in particular forms and not by others.

Employee disagreement over the desirability of particular nontaxable benefits has historically served as a restraint on the amount of tax-free compensation provided in any one form.

Cafeteria plans virtually eliminate this restraining factor by permitting individual employees to select the fringe benefits which meet their particular needs. In addition, where an employer is unwilling for a variety of reasons to provide additional benefits on a tax-favored basis, cafeteria plans enable employees to use pre-tax dollars rather than after-tax dollars to purchase such additional benefits.

Our revenue estimates with respect to cafeteria plans indicates a significant impact which they may have on the Federal tax base. For fiscal years 1984 through 1989, we estimate that cafeteria plans will reduce individual income tax receipts by $7 billion and Social Security receipts by over $3 billion, for a total reduction of $10.2 billion over those 5 years. These projections indicate that cafeteria plans provide a powerful incentive for structuring nontaxable compensation packages. Even more substantial revenue losses would result if the cafeteria plans rules authorize the exclusion of benefits through the so-called flexible spending arrangements, that is the FSA's that we discussed in the DEFRA conference committee. Generally, an FSA permits an employee to designate some portion of his or her otherwise taxable salary as available for tax-free reimbursement of a specified expense such as medical care, legal services, or dependent care systems. We have concluded, and the proposed Treasury regulations reflect this conclusion, that the statutory provisions granting tax-favored treatment to specified benefits—the cafeteria rules themselves do not authorize flexible spending accounts. Therefore, the benefit does not fall under any of the applicable statutory exclusions if the benefit is provided through an FSA. If FSA were granted favorable tax treatment, employers would be better able to style ordinary compensation as tax-free reimbursement of their employees' personal expenses.

The effect would be to write out of the Code for employees covered under cafeteria plans the existing limits on deductions and credits for a number of personal expenses. This would have a dramatic effect on the revenue base. The figures I gave earlier—a little over $10 billion for the years 1984 through 1989 through the use of cafeteria plans—would be approximately doubled if flexible spending accounts were allowed.

Let me turn to welfare benefit plans including VEBA's. Generally, the cost of employee compensation, including employer-provided welfare benefits, are deductible by the employer at the time the compensation is actually provided to the employee. Also, if an employer sets aside amounts for future employee compensation, income earned on the amount set aside are included in the employer's gross income for income tax purposes. There are exceptions to these general rules, and they have permitted employers in certain circumstances to deduct currently contributions to prefund deferred welfare benefits. The critical advantage to an employer in setting aside funds in VEBA's and other effectively tax-exempt entities is that the income on the funds accumulate on the tax-exempt basis—generally, neither the employer, the VEBA, nor the employee beneficiaries are taxed currently on the fund's growth.

The historical development of VEBA—the VEBA rules—indicates that the effectively unlimited tax exemption for VEBA's did not come about in a considered and deliberate fashion. Basically, Mr. Chairman, prior to 1969 there was a limit of 15 percent on the income—the outside income—that could be earned by a VEBA, and this prevented employers from using VEBA's to accumulate substantially tax-favored reserves. In 1969, the Tax Reform Act of 1969, in an apparent attempt to restrict VEBA's, made VEBA's subject to the unrelated business income tax, and the 15 percent test was thought to be meaningless and was removed. This left VEBA income not subject to tax if it is set aside to provide permissible benefits, and thus there is no longer any limit on the amount that an employer can set aside in a VEBA to pay a permissible benefit or on the tax-free earning that can accumulate inside a VEBA.

In recent years, we have seen a significant growth in the number of VEBA's. According to IRS, there were some 7,700 active VEBA's that had received favorable IRS determinations as of 1980. By the end of 1983, that had jumped 20 percent—9,400 had received favorable letters. So, in the last 3 years, we have seen a 20-percent increase, even though VEBA's have been in existence for—have been tax-exempt—for 54 years.

One of the reasons, we think, for this increase was the enactment of the additional limits under section 415 on contributions and benefits, and the top-heavy rules under qualified pensions and profit-sharing plans. VEBA's are not subject to either of these restrictions. The combination of the current deduction for deferred welfare benefits and the tax-exempt growth of funds set aside for benefits provides employers with substantial tax benefits to the extent that the employee is able to pre-fund on a deductible basis his deferred benefits to a tax-exempt entity. A portion of the cost of the benefit will be purchased with tax-exempt income earned by that entity, and the benefit to the employer can far exceed the 46 percent that is normally available for an employee benefit that is simply deductible when paid. It is important to note that this shifting of costs from the employer to the Government occurs even though the funding is actuarily sound. The problem is by no means limited to the overfunding case.

The Deficit Reduction Act contains rules that limit the extent to which the employer may use a VEBA or similar entity to provide deferred benefits to employees. If a reserve is set aside in a VEBA in excess of these reserve limits established in the 1984 Act, the income of the VEBA is subject to unrelated business income tax. The Act also has rules aimed at limiting the extent to which an employer can use a VEBA or similar entity for the intended purposes. We worked with Senator Packwood on those rules very closely. We would just point out that, even with these limits, there are very significant tax benefits remaining for employers using the VEBA's or similar entities. And I think those ought to be inquired into in these hearings and I am sure that will be discussed at some length.

Now, let me shift very quickly to the equity questions raised by fringe benefits. The statutory exclusion from gross income are, of course, generally conditioned on the delivery of the benefits through an employer-sponsored plan. The limitations of these benefits to employees covered by an employer plan may be seen to discriminate against individuals who are not covered by plans. Noncovered individuals are going to have to pay for these benefits, such as health care, with after-tax dollars, where the covered employees are able to purchase the same benefits with pre-tax dollars. If there is an unfairness here, it is exascerbated as a percentage of compensation paid in the form of fringe benefits increases over the years.

There are also nondiscrimination problems. A basic justification for providing a tax benefit in the form of an exclusion from gross income is to promote the delivery of a tax-favored benefit to a broad cross section of employees. We think it is important, as do the members of this committee, that effective coverage and nondiscrimination rules apply with respect to each employer provided benefit eligible for an exclusion. Over the last few years, I think we have all begun to recognize that, as Senator Packwood said, coverage and nondiscrimination rules apply to most of the benefits. An exception is medical plans under a policy with an insurance company, which are not subject to the nondiscrimination rules. We would suggest that you look at that in these hearings.

We are also concerned that cafeteria plans undermine the effectiveness of the statutory coverage and nondiscrimination rules. Nondiscrimination rules are generally based on the availability of the particular benefits provided under the plan. In the absence of a cafeteria plan, an availability type test will ordinarily assure that the benefit is provided to a broad cross section of employees, but availability based tests are not effective where the employees are free to trade tax-favored benefits for cash or other benefits, and I think that is an aspect of cafeteria plans with which we should be concerned.

And then, finally, Mr. Chairman, let me just mention the health policy considerations since they are such an important part of this entire area. The magnitude of the tax benefits available for employer-provided welfare benefit plans may create incentives inconsistent with other important policy objectives. In particular, we are concerned that the generous tax treatment of employer-provided health benefits may have contributed to, rather than have contained, increasing health care costs. Under the code, there have been unlimited exclusions from gross income for the cost of employer provided health coverage and medical care and expense reimbursements received under such coverage are also provided with an unlimited exclusion. The primary effect of these provisions is that employees are supplied with extraordinarily generous health benefits, often with no internal controls or cost or utilization of health care.

Some employer-provided health plans are so generous that employees bear little if any of the cost of routine doctors visits, health care or medical tests. And as a result, the employees tend to overuse doctors and hospital services. Such overuse contributes to rising health care costs. In recognition of this impact from the tax laws, the administration proposed a cap on a health benefit premium that may be excluded from an employee's gross income. There may be additional methods of encouraging employers to introduce more cost sharing into their health plans and to otherwise reduce private health spending. We think all parties—Congress, the administration, and private industry—should work together in an attempt to target tax benefits for health plans more effectively than they are today.

Also, we believe that the health care cost considerations dictate that favorable tax treatment not be granted to flexible spending accounts and to cafeteria plans. Because FSAs would allow existing cost sharing in health plans to be made with pretax dollars, the permissive treatment of FSA's would contribute to rising health care costs. The Department of Health and Human Services concurs in this analysis, and we have worked with them on this part of the testimony.

We recognize the argument in particular situations—and certainly, I have heard it a lot—that if an FSA replaces first dollar of coverage, the FSA may introduce a relative incentive for employees not to use health care. But we have got to recognize that in granting favorable tax treatment, the FSA's would permit employees to use pretax dollars to pay for health-related expenses that are currently paid with after-tax dollars.

These expenses—cost sharing under health insurance, payment for services not covered by insurance, and employee contributions to employer-sponsored health care plans—are expected to go to $118 billion by 1990 according to HHS estimates. If through the availability of flexible spending accounts a substantial share of that $118 billion were to be financed with pretax dollars, the demand for health services would be increased, and health care costs inflation exacerbated. More effective and equitable strategies than FSA's are available to aid employees in controlling health care costs, and just as one example we would point out the cafeteria plans without FSA's permit employers to price health benefit options to encourage employees to select the options with additional employee cost sharing. An employee who selects the lower option health benefit would then have additional amounts available to purchase other benefits or to receive in cash, which he could in turn use to pay for health expenses that are unreimbursed due to the higher deductible or copayment. And there are certainly other ways to attack this problem.

Mr. Chairman, I will conclude my summary of my statement there, and I will be happy to answer any questions.

[Mr. Chapoton's prepared statement follows:]

For Release Upon Delivery
Expected at 9:30 a.m., E.D.T.
July 26, 1984

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to present the Treasury Department's views on the appropriate tax treatment of employer-provided fringe benefits.

In the just-enacted Deficit Reduction Act of 1984 (DRA), Congress made several significant changes in the rules governing fringe benefits. Among the more important of these were (i) the extension to retired and disabled employees of the limits applicable to tax-favored group-term life insurance; (ii) the application of deduction and other limits to voluntary employees' beneficiary associations (VEBAs) and other welfare benefit funds; (iii) the codification of an exclusion for formerly nonstatutory fringe benefits, such as employee discounts and free parking; and (iv) the exclusion from cafeteria plans of taxable benefits other than cash, group-term life insurance in excess of $50,000, certain group-term life insurance for dependents of the employee, and vacation days. The DRA also adopted reporting requirements, key employee limits, and special transition rules for cafeteria plans.

The DRA was an appropriate step in rationalizing the Federal tax treatment of fringe benefits. Needed clarification was provided to individual taxpayers and employers alike, and progress was made in limiting the expansion of fringe benefits.

My testimony today will outline areas of continuing concern to the Treasury Department with regard to the tax treatment of employee fringe benefits. I will focus on the so-called statutory fringe benefits, those benefits exempted from tax under specific provisions of the tax law, and will discuss in particular the growth in fringe benefits provided under employer-sponsored welfare benefit plans.

We are concerned that the expansion of the fringe benefits excluded from the Federal income and social security tax bases has caused tax rates to be higher than they would otherwise be. Our efforts in recent years to contain increases in marginal rates of income taxation and in the social security tax rates could be undermined quickly by any significant narrowing of the range of compensation subject to tax.

We are also concerned that the tax benefits derived from the existing statutory fringe benefits are not fairly distributed among taxpayers. Current provisions direct a disproportionate share of such preferences to individuals able to participate in employer-sponsored benefit plans.

Finally, we are concerned that in some instances the exclusion of benefits from gross income fails to promote the policies underlying such favorable treatment.

Impact on the Income and Social Security Tax Bases

Statutory Nontaxable Benefits

Generally, an employee is required to include in gross income, for both Federal income and social security tax purposes, all amounts received as compensation, whether in the form of cash or any other benefit, including welfare benefits. Subject to statutory limits, however, benefits provided under an employer-sponsored plan that satisfies the applicable Code provisions are excluded from the income and social security tax bases.

Generally, a employer-provided benefit qualifies for an exclusion only if the plan satisfies certain eligibility, coverage, and nondiscrimination rules. (A notable exception is health benefits provided by an employer under a policy of insurance with an insurance company.) The purpose of these rules is to assure that the tax-favored benefit is provided to a broad cross-section of the employer's employees on a nondiscriminatory basis.

Prior to the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), the major statutory fringe benefits were qualified profit-sharing and pension plans, group-term life insurance, and medical benefits. The favorable tax treatment was intended to encourage employer to provide benefits that would protect employees and their families from hardship on account of separation from service, death, and sickness or disability. Beginning with ERISA, however, the statutory exclusion of fringe benefits from taxation has grown to include employee stock ownership plans, group legal services programs, van pooling, educational assistance programs, and dependent care assistance programs.

The expansion of the statutory nontaxable benefits has the effect of reducing the cost of a broad range of goods or services that are purchased by a wide spectrum of the population. Predictably, the broader range of nontaxable benefits has put pressure on employers to provide increasing portions of compensation in tax-favored forms so as to maximize the "tax effectiveness" of employee compensation packages.

Various surveys, based primarily on Department of Commerce and U.S. Chamber of Commerce data, reveal that the percentage of total compensation that is paid in the form of "agreed-upon" fringe benefits (e.g., qualified plan benefits and employer-provided health benefits), as compared with legally required benefits (e.g., unemployment compensation and workers compensation), has consistently increased over the last twenty-five years. For example, one survey indicates that the percentage of total compensation paid in the form of "agreed-upon" benefits was 2.6 percent in 1950, 6 percent in 1970, 8.9 percent in 1980, and 9.8 percent in 1983.

Cafeteria Plans and Flexible Spending Arrangements

The growth in tax-favored benefits provided under employer-sponsored plans has been further stimulated by the statutory authorization of cafeteria plans. Cafeteria plans permit individual employees to pick and choose which fringe benefits they will receive, in effect allowing employees to design fringe benefit packages tailored to their individual needs.

The flexibility inherent in cafeteria plans substantially eliminates "employee jealousy" as a restraint on the amount of compensation provided in tax-favored forms. In the absence of a cafeteria plan, employees would choose compensation in the form of nontaxable fringe benefits only if the benefits were more desirable than the after-tax value of the additional salary that would otherwise have been paid. Because the desirability of particular benefits differs from employee to employee, fringe benefit compensation is generally sought by some employees and opposed by others. Employee disagreement over the desirability of particular nontaxable benefits has served historically as an important restraint on the amount of compensation provided in any one form. Cafeteria plans virtually eliminate this restraining factor by permitting individual employees to select the fringe benefits which meet their particular needs.

Also, where an employer is unwilling to provide additional benefits on a tax-favored basis, cafeteria plans enable employees to use pretax dollars, rather than after-tax dollars, to purchase such additional benefits. For example, in the absence of a cafeteria plan, an employee would have to make the required employee contribution to a contributory medical plan with after-tax dollars. But if the employer makes the contributory medical plan available through a cafeteria plan, the employee would be able to make the required contribution with pretax dollars.

Our revenue estimates reflect the significant impact cafeteria plans have on the Federal tax base. For fiscal years 1984 through 1989, we estimate that, assuming the exclusion for group legal services is not extended beyond December 31, 1984, cafeteria plans will reduce individual income tax receipts by $7.01 billion and social security receipts by $3.2 billion, for a total reduction of $10.21 billion. (If the exclusion for group legal services is extended, the appropriate estimates are $7.47 billion and $3.42 billion, respectively, for a total of $10.89 billion.)

These projections indicate that cafeteria plans provide a powerful incentive for structuring nontaxable compensation packages. Even more substantial losses in revenue would result, however, if the cafeteria plan rules authorized the exclusion of benefits provided through "flexible spending arrangements." Generally, a flexible spending arrangement (FSA) permits an employee to designate some portion of his or her otherwise taxable salary as available for the tax-free reimbursement of specified expenses, such as medical care, legal services, or dependent care assistance. Under an FSA, the employee is assured of receiving, in the form of cash or some other benefit, any portion of the designated amount available for tax-free reimbursement without regard to whether the employee incurs covered expenses.

We have concluded, as proposed Treasury regulations on cafeteria plans reflect, that the statutory provisions granting tax-favored treatment to specified benefits and the cafeteria plan rules themselves do not authorize FSAs. Therefore, a benefit does not fall under any of the applicable statutory exclusions if the benefit is provided through an FSA.

If FSAs were granted favorable tax treatment, employers would be better able to style ordinary compensation as a tax-free reimbursement of their employees' personal expenses. Such expenses are otherwise nondeductible for tax purposes, or, as in the case of expenses for medical or dependent care, entitled to a deduction or credit only under statutory limitations. The effect of granting favorable tax treatment to FSAs would be to write out of the Code, at least for employees in cafeteria plans, the existing limits on deductions and credits for a number of personal expenses.

The dramatic effect that FSAs would have on the Federal tax base is again reflected by our revenue estimates. For the 1984 through 1989 fiscal years (assuming that the exclusion for group legal services is not extended beyond December 31, 1984), we estimate that granting favorable treatment to FSAs would cause a $6.71 billion loss in individual income tax receipts and a $3.11 billion loss in social security tax receipts, for a total loss of $9.82 billion. (If the group legal exclusion is extended, the estimates are $8.47 billion and $3.91 billion, respectively, for a total loss of $12.38 billion.) These estimates are in addition to the earlier estimates of the reductions in receipts due to cafeteria plans generally. Thus, for the fiscal years 1984 through 1989, the aggregate revenue estimate of continuing cafeteria plans and granting favorable tax treatment to FSAs is $20.02 billion (group legal not extended) and $23.27 billion (group legal extended).

Welfare Benefit Funds, Including VEBAs

Generally, the costs of employee compensation, including employer-provided welfare benefits, are deductible by the employer at the time when the compensation is actually provided to the employees. In addition, if an employer sets aside amounts for future employee compensation, income earned on the amounts set aside is included in the employer's gross income for income tax purposes.

Exceptions to these general rules have permitted employers, in certain circumstances, to deduct currently contributions to prefund deferred welfare benefits. The critical advantage to an employer in setting aside funds in VEBAs and other effectively tax-exempt entities is that the income on such funds accumulates on a tax-exempt basis. Generally, neither the employer, the plan or VEBA, nor the employee-beneficiaries are taxed currently on the fund's growth.

The historical development of the VEBA rules indicates that the effectively unlimited tax-exemption for VEBAs did not come about in a considered and deliberate fashion. Indeed, before the DRA, Congress seems not to have appreciated the potentially substantial tax benefits that an employer could derive through a VEBA. Instead, Congress generally viewed VEBAs simply as vehicles through which employees could join together to provide certain welfare benefits for themselves without adverse tax consequences.

Congress originally enacted a statutory tax exemption for VEBAs in 1928. The exemption was available only for VEBAs with respect to which at least 85 percent of the income was collected from members to pay benefits or administrative expenses. Later, in response to the Internal Revenue Service's argument that employer contributions, if in excess of 15 percent of a VEBA's income, destroyed the VEBA's tax-exempt status, Congress provided that employer contributions would be treated as member contributions for purposes of the 85 percent test.

Even after the change in treatment of employer contributions, the 85 percent test, by effectively limiting the investment income in a VEBA to 15 percent of the VEBA's income, prevented employers from using VEBAs to accumulate substantial tax-favored reserves. The Tax Reform Act of 1969, however, in a move apparently intended to restrict the tax advantages of VEBAs, subjected VEBAs to the unrelated business income tax and eliminated the 85 percent test; Congress appeared to believe that the unrelated business income tax rendered the 85 percent test unnecessary. Under the applicable unrelated business income tax provisions, however, VEBA income was not subject to tax if it was "set aside" to provide permissible benefits. Thus, there were no longer any limits on the amounts that an employer could set aside in a VEBA to pay a permissible benefit, or on the tax-free earnings that could accumulate on the amounts set aside.

In recent years, and especially since Treasury regulations under the Tax Reform Act of 1969 were issued in 1980, the growth in the number of VEBAs has substantially accelerated. According to the IRS, only 7,791 active VEBAs had received favorable IRS determination letters by November 30, 1980. By the end of 1983, however, more than 9,400 VEBAs had received favorable letters.

Thus, nearly 21 percent of the VEBAs in existence as of the end of 1983 have come into existence during the last three of the 54 years for which VEBAs have been tax-exempt. One of the reasons for this recent increase was the enactment of the additional limits--the reduction in the section 415 limits on contributions and benefits and the top-heavy rules--on qualified pension and profit-sharing plans in the Tax Equity and Fiscal Responsibility Act of 1982. VEBAs are subject to neither of these restrictions.

The combination of the current deduction for deferred welfare benefits and the tax-exempt growth of funds set aside for such benefits provides employers with substantial tax benefits. For example, an employer that is subject to a 46 percent marginal income tax rate generally bears about 54 percent of the cost of providing an employee with a welfare benefit and the Federal government (or taxpayers generally), through the tax system, bears about 46 percent of the cost of the benefit. To the extent that the employer is able to prefund, on a deductible basis, a deferred benefit through a tax-exempt entity, such as a VEBA, a portion of the cost of the benefit will be purchased with tax-exempt income earned by the entity. In such a case, the Federal government (or taxpayers generally) will pick up a greater share of the total cost of the benefit. If the prefunding occurs many years in advance of when the benefit is provided, the government's share of the cost will far exceed the employer's share due to the greater accumulation of tax-exempt income. It is important to note that this shifting of costs to the government occurs even though the funding is actuarially sound. Thus, the problem is by no means limited to cases where overfunding occurs.

One way of illustrating the magnitude of this tax benefit is by comparing the after-tax amounts generated if the same amounts are set aside, over a period of years, on a tax-deductible and tax-exempt basis, on the one hand, and on a non-deductible and taxable basis, on the other. For example, assume that a corporation is willing to devote $2,000 at the beginning of each year for 10 years toward providing a benefit at the end of the 10th year. Assume further that the corporation is in the 46 percent tax bracket for each of these years, and that the annual interest rate is 10 percent.

If the corporation uses a VEBA to fund the benefit, it will be allowed to deduct the $2,000 in each year of its contribution to the VEBA. If, however, the corporation merely uses a taxable bank account to fund the benefit, it will be able to set aside in each year only the after-tax value of $2,000, which is $1,080. After ten years of accumulation, the VEBA fund will be $35,062.33, whereas the balance in the bank account will be only $14,587.83. The bank account balance, however, will support a benefit of $27,014.50, which would be financed by the deduction for this benefit (.46 x $27,014.50) and the $14,587.83 account balance. Thus, funding the benefit through the VEBA permits the corporation to provide a 30 percent greater benefit than funding through the taxable bank account.

The DRA contains rules that limit the extent to which an employer may use a VEBA or similar entity to provide deferred benefits to employees. Employer deductions to a VEBA for a year are limited to the sum of the benefits provided during the year plus an amount, determined under reasonable actuarial standards, to cover benefit claims incurred but unpaid as of the end of the taxable year and to cover projected post-retirement life insurance and medical benefits. Also, if the reserves set aside in a VEBA or similar entity exceed the permitted reserve limits, the income of the VEBA or similar entity will be subject to the unrelated business income tax. Finally, the DRA limits the levels of benefits that may be provided to employees for purposes of calculating these deduction and reserve limits. These rules generally are effective for years beginning after December 31, 1985.

The DRA also contains rules aimed at limiting the extent to which an employer may use a VEBA or similar entity for unintended purposes. For example, the DRA applies eligibility, coverage, and nondiscrimination rules to VEBAs and provides that funds set aside to provide post-retirement life insurance and health benefits to a key employee of the employer must be credited to a separate account and must be counted under the annual section 415 limits as employer contributions to a defined contribution plan. Also, a key employee may receive the promised post-retirement benefits only out of the funds credited to his or her separate account. In spite of the important limits imposed by the DRA, significant tax benefits remain for employers using VEBAs or similar entities.

Horizontal Inequity

The statutory exclusions of fringe benefits from gross income generally are conditioned upon the delivery of the benefits through an employer-sponsored plan. (An exception is the exclusion for health benefits provided under a policy with an insurance company.) The limitation of tax-favored benefits to employees covered by an employer plan may be seen to discriminate against individuals not so covered. This latter group of non-covered individuals must pay for benefits, such as health care, with after-tax dollars, whereas covered employees are able to purchase the same benefits with pretax dollars.

It is worth noting that the degree of unfairness attributable to the tax treatment of fringe benefits varies directly with the volume of benefits exempted from tax. As the percentage of compensation paid in the form of fringe benefits has increased, the issue of how the related tax benefits are distributed among taxpayers has taken on increasing importance. Further growth in the volume of fringe benefits can only exacerbate already significant concern over taxpayer fairness.

Nondiscrimination and Health Policy Objectives

Nondiscrimination

A basic justification for providing a tax benefit in the form of an exclusion from gross income is to promote the delivery of the tax-favored benefit to a broad cross-section of employees on a nondiscriminatory basis. It is thus important that effective coverage and nondiscrimination rules apply with respect to each employer-provided benefit eligible for an exclusion from gross income.

Coverage and nondiscrimination rules apply to most tax-favored benefits, such as group-term life insurance, self-insured medical reimbursement plans, group legal service plans, and dependent care assistance programs. However, medical plans provided by an employer under a policy with an insurance company are not subject to nondiscrimination rules. Thus, discrimination in favor of the key and highly compensated employees is still possible in the case of insured health plans.

We are concerned that cafeteria plans undermine the effectiveness of the statutory coverage and nondiscrimination rules that presently apply with respect to the statutory exclusions. These nondiscrimination rules generally are based on the availability of the particular benefit provided under the plan. In the absence of a cafeteria plan, an availability-type test ordinarily will assure that the benefit is provided to a broad cross-section of employees on a nondiscriminatory basis. Availability-based tests, however, are not effective where employees are free to trade tax-favored benefits for cash or other benefits. Also, the existing nondiscrimination rules applicable to cafeteria plans generally are not adequate to assure that the underlying nondiscrimination objectives are being protected.

Health Policy Considerations

The magnitude of the tax benefits available for employer-provided welfare benefit plans may create incentives inconsistent with other important policy objectives. In particular, we are concerned that the generous tax treatment of employer-provided health benefits may have contributed to, rather than contained, increasing health care costs.

Section 106 of the Code provides employees with an unlimited exclusion from gross income for the cost of employer-provided health coverage. Medical care and expense reimbursements received under such coverage are provided with an unlimited exclusion under section 105(b). A primary effect of these provisions is that employees are supplied with extraordinarily generous health benefits, often with no internal controls on costs or utilization of health care. Some employer-provided health plans are so generous that employees bear little, if any, of the cost of routine doctors' visits, hospital care, or medical tests. As a result, the employees tend to overuse doctor and hospital services and medical tests. Such overuse contributes to rising health care costs.

In recognition of the effect on health care costs of the tax treatment of employer-provided health benefits, the Administration has proposed a cap on the health benefit premium that may be excluded from an employee's gross income. There may be additional methods of encouraging employers to introduce more cost-sharing into their health plans and otherwise to reduce private health spending. All parties--Congress, the Administration, and private industry--should work together to target the tax benefits for health plans more effectively.

Furthermore, we believe that health care cost considerations also dictate that favorable tax treatment not be granted to FSAs in cafeteria plans. Because FSAs would allow existing cost-sharing in health plans to be made with pretax dollars, the permissive treatment of FSAs would contribute to rising health costs. The Department of Health and Human Services concurs in this analysis.

We recognize the argument that, in particular situations where an FSA replaces first-dollar coverage, the FSA may introduce a relative incentive for employees not to use health care. However, granting favorable tax treatment to FSAs would permit employees to use pretax dollars to pay for health-related expenses that are currently paid with after-tax dollars. These expenses--cost-sharing under health insurance, payments for services not covered by insurance, and employee contributions to employer-sponsored health plans--are expected to grow to $118 billion by 1990, according to Department of Health and Human Services estimates. If, through the availability of FSAs, a substantial share of the $118 billion were to be financed with pretax dollars, demand for health services would be increased and health care cost inflation exacerbated.

More effective and equitable strategies than FSAs are available to aid employers in controlling health care costs. For example, both prospective and retrospective hospital utilization review, second opinions, restructuring of benefits (e.g., to cover noninstitutional care), special service delivery arrangements (e.g., preferred provider organizations), and the promotion of health maintenance organizations are examples of proven and developing strategies for private health cost containment. Also, cafeteria plans without FSAs permit employers to price health benefit options to encourage employees to select the options with additional employee cost-sharing. An employee who selects a lower-option health benefit then would have additional amounts available to purchase other benefits or to receive as cash, which if necessary could be used to pay for health expenses that are unreimbursed due to the higher deductible or co-payment.

We believe thorough analysis clearly indicates that even though FSAs may facilitate particular employers in attempting to introduce incentives for employees not to use health care, the dominant effect of granting permissive tax treatment to FSAs would be to increase health care costs. We thus believe, and the Department of Health and Human Services concurs, that granting such treatment to FSAs would undercut the effort to formulate an effective health cost containment policy.

Senator PACKWOOD. Buck, let me ask you one quick question on health. Are you familiar with Pepsico's experience when they moved their health plan from a cafeteria plan to a flexible spending plan?

Mr. CHAPOTON. I am not sure I am familiar with Pepsico, but I know that several employers have done that and they have reduced the cadillac nature of their health plans. And in those particular situations, I think they can make a pretty good case that their health care costs have been reduced. I think——

Senator PACKWOOD. The Treasury's revenue has increased thereby.

Mr. CHAPOTON. Because you are shifting from taxable to nontaxable benefits. But to the extent the benefit is provided under the flexible spending account—in health care costs, to the extent you reimburse for eyeglasses, to the extent you reimburse for medical benefits not under the plan—it is still tax free. Moreover, the pressure to spend that money on that health care benefit is there, rather than to take it in cash.

On an overall basis, we concede that those can be health saving costs in a particular situation, but overall when we pay per cost of pretax dollars, we have to know that we are increasing the demand for those costs.

Senator PACKWOOD. Going back to my labor relations experience and reading the statements of witnesses, my hunch is you are going to see more and more of these negotiated plans having coinsurance or some kind of deductible. The pressure of the cost is such that the employer is simply saying we have got to have coinsurance or a deductible. We cannot afford to pay the first dollar of coverage for our employees. That seems to be growing.

Mr. CHAPOTON. I think that is correct.

Senator PACKWOOD. Eight or ten years ago a humorous story appeared in the New York Times when the Israeli doctors went on strike. Israel had almost womb to the tomb coverage and first dollar coverage although funded through the government. The doctors claimed it was being abused. People were coming in and taking advantage of every little thing to come to the doctor's office. They went on strike for 28 days. During the 28 days, the death rate dropped dramatically in Israel. [Laughter.]

Senator PACKWOOD. I don't know what that concludes.

Mr. CHAPOTON. I am not sure I know that either, but that is interesting.

Senator PACKWOOD. Buck, do you think that all individuals should provide for their own health coverage, rather than having it collectively provided either by the Government or by employers?

Mr. CHAPOTON. I think clearly some employer-provided health care makes sense. We have covered a broad spectrum of the population with good health care coverage. That has been a very desirable thing. I think it has obviously tended to use health care more than we would have otherwise used it, but we do need to worry about the tremendous increase in costs but, as you point out, there are a lot of ways to attack the cost problem. And moving away from first dollar coverage and copayment coverage is certainly a way to go. But we are not at all saying that we would do away with it.

Senator PACKWOOD. Do you think there is any doubt we would have national health insurance today had employers not adopted these broad-based health coverage plans? Unions deserve a great deal of credit for this because they negotiated the early plans and then other employers who were nonunion followed suit.

Mr. CHAPOTON. I don't want to jump to that conclusion. There certainly would have been a lot more pressure for it. No doubt about that.

Senator PACKWOOD. Do you have any question, despite the escalating costs, covering the bulk of the people we now cover with health insurance, it is probably cheaper the way we do it than if we had the equivalent of national health insurance?

Mr. CHAPOTON. Mr. Chairman, that is getting out of my area of expertise. I would suspect that is true, but I really have no——

Senator PACKWOOD. I look at the cost for the coverage of medicaid and medicare. Now, admittedly, with medicaid you are talking about poor people who are more likely to be sick and with medicare, obviously, an older population. It has a higher proportion of costs. But if I look at those two programs and the costs, it is impossible to extrapolate back to a Government program providing roughly the kinds of coverage that private health insurance now covers. I am willing to wager that private health insurance saves this Government a bundle of money in terms of comparing the lost revenues from the tax exemption for health insurance versus what it would cost the Government to provide that same kind of coverage.

Again, that is hard to prove, but having looked at everything else that Government manages, I find it hard to believe we would manage a national health insurance system well, or cheaply.

Mr. CHAPOTON. I think the next step, though, as you point out, is employers bringing more pressure to bring health care costs down. And I think they are feeling the pinch and are indeed clearly doing it. And that is why the cafeteria plan rises to the front. We recognize that, and I think we all ought to be aboveboard though in saying and recognizing that the flexible money account is simply not an answer to it. In an individual case they might use and think that it helps their negotiations with their employees, but overall we do not see it as helping.

Senator PACKWOOD. If I thought that the people who wanted to tax employee benefits really only wanted to make them more efficient, I think there would be room for negotiation. While I wouldn't like the taxation idea, if that is what we were striving for, I think there would be room for compromise.

I sense that a great many people don't want some of these benefits provided collectively, whether it is by the Government or by business. So they are using the tax subterfuge in the hopes of crippling or eliminating these benefits. I don't accuse you of that, but I think that motivates a number of people.

Mr. CHAPOTON. I think the thing we have to worry about, Senator Packwood, is the growth in the area. And when you see an infringement on the tax base becoming dramatic, I think you have to worry about it. Whether you worry about it from a tax policy standpoint solely or from the other social standpoints, it is a matter of concern. I would shift to one thing. It may be the same point that you are making.

Say, for retirement benefits, qualified pensions, and profit-sharing plans—they now have meaningful limits on them. The nondiscrimination rules work generally well. We have some other changes that we would make, but basically. I think people are generally happy with such plans.

Clearly, they take significant pressure off of Social Security. I don't think anybody is talking about backing away on that.

Senator PACKWOOD. Well, let's take one that really isn't on the cutting edge, although John Chafee has mentioned auto care. You know my story on that. Years ago I made a speech and kiddingly at the end of it said, you know what bothers your employees more than anything else? More than health care or vacations? It is getting their cars fixed. What you really ought to provide is auto care for your employees.

The group kind of laughed. A fellow came up afterward and said, Senator, you won't believe this, but our company has auto care. I said really? He said yes. I asked him who he was and he said he was Paul Parker, and he was a vice president of General Mills. They have this plant that they had just put up about 30 miles outside Minneapolis.

Then, it was really out in the sticks, and there were no good auto repair facilities nearby. They were losing too much time—people coming to work late or leaving work early to go get their cars fixed. So, they put up a six-bay auto repair facility on their parking lot. And they fixed their employees' cars. The mechanics are General Mills employees. The parts and labor are about 30 percent less than you would pay to have it done elsewhere, and General Mills will stand behind the work. Bring it in once and don't like it, bring it in again. If you don't like it, bring it in again. The third time, if you don't like it, they will give you your money back, and you can take it wherever else you want to go.

I asked Mr. Parker how the employees liked it. He said like it? We could get rid of vacations and health insurance before we could get rid of auto care. [Laughter.]

Now, I am not suggesting that that become a nontaxable fringe benefit, but let's take as an example day care. At the moment, it is a nontaxable benefit. Should it be?

Mr. CHAPOTON. I think it is very popular and I am not nearly prepared to say it should not be. I think, in fact, we have been very supportive of day care. I think you ought to look to see who is using it and whether it is serving its purpose. We do have to always recognize that when we provide a benefit such as that through an employer plan that is not provided to nonemployees, then we do have a unfairness about it.

Senator PACKWOOD. What do you mean "nonemployees"?

Mr. CHAPOTON. For instance, a self-employed person who takes a child to a day care center does not receive the same benefit.

Senator PACKWOOD. Oh. I am perfectly prepared to extend it that far. We could do that now.

Mr. CHAPOTON. Or work for an employer that doesn't provide day care. I think from a broader social standpoint, if you want to give a tax benefit there, you probably ought to do it for everyone, even though I am not prepared——

Senator PACKWOOD. You mean you ought to mandate it?

Mr. CHAPOTON. No, not mandate. You simply allow a deduction or allow through the tax system benefits whether or not the employer provides a plan. Now, we leave it to employers.

Senator PACKWOOD. With that I would agree. All of the unincorporated partnerships that exist where you can take the benefits for your employees but not for yourself, but if you are incorporated, you could. And that is unfair.

Mr. CHAPOTON. Or I think the logical case would be employees whose employers do not have such plans. But again, we have to recognize we are eroding the tax base whenever we do it.

Senator PACKWOOD. We are not eroding it, however, as much as if the Government provided the day care.

We have all seen comparative studies done. The best one I recall was the Division of Direct Reimbursement that we put into the Medicare bill. The argument was made that the middle man—the insurer—was going to take too big a portion of the costs for Medicare, and so certain providers could send their bills directly to the Government, and skip the insurance company. The Division of Direct Reimbursement would then reimburse them. We had some good comparisons of that Division versus Blue Cross of Maryland. Blue Cross of Maryland was the best one because the headquarters was located very close to the Division of Direct Reimbursement. They drew relatively from the same employment pool of the neighborhood. They had the same traffic problems, weather problems, and so forth. The Divison of Direct Reimbursement's costs per claim were just outrageous in comparison to Blue Cross' costs for the identical kind of coverage. It is just one more example of a Government service provided badly.

Mr. CHAPOTON. I think that that point is well taken. You certainly have to decide that it is a service that the Government would otherwise undertake.

Senator PACKWOOD. Let me ask you one last question. At the moment, employee-provided legal services are tax deductible. Should they be?

Mr. CHAPOTON. We were examining that question in connection with our fundamental reform effort. I am not prepared to say. I think if we had to take a position today, we would say that they should not be certainly, but we are not required to take a position today. We will be doing so. I frankly do not see that that is a service that the Government would otherwise undertake.

Senator PACKWOOD. Oh, I will make you a bet. You are going to see Government legal services grow and grow, if there is not an alternative provision. And we are going to fund it. You seriously don't contend that and I am not talking about the divorces that you see advertised or the wills that you can get done for $150 or $220. The average person who gets stuck with a serious lawsuit who doesn't have insurance. They can't afford a lawyer. You know it. I know it. They can't afford it.

Mr. CHAPOTON. But if you provide it in a lawyer or legal services plan, you don't limit it to that case. You cover people who would otherwise be able to afford it, and you also tend to encourage people to take more of that service than they would otherwise take. We know that.

Senator PACKWOOD. Is that true of day care and health insurance, too?

Mr. CHAPOTON. That is a problem with all these. Correct. And in addition, we have to recognize that while we are attempting to limit Federal spending—and we spend a lot of time worrying about that, and Senator Symms and you and I all worry about it—that on the one hand, we are trying to limit Federal spending, but with the other hand, we are doing basically the same thing through the tax system. And so, it is even probably more difficult to get a direct handle on it than you do through the tax system.

Senator PACKWOOD. Steve?

Senator SYMMS. Thank you very much, Mr. Chairman. I want to thank you for holding these hearings, and Buck, for your being here as the first witness. I think this is an issue that really is of great importance to the working men and women of the country and to their families.

And I was very pleased, Mr. Chairman, in the passage of—virtually we enacted S. 1817, which we voted on in here in the passage of the Deficit Reduction Act here a couple of weeks ago—but we passed my bill. We didn't accept it here in the committee, but it was virtually accepted in conference, and I appreciate the work that was done to have that happen.

But there was one controversial area that I thought was a grave mistake, and it was not the Senate conferees that rejected, but the House Democrats basically, and I hope we can get bipartisan support here in the Senate. I would be glad to ask you about it, Buck, and that is for the employee-provided educational assistance benefits. At a time when we have a work force that has to be retrained from some industries that have saturated the market into a more service oriented industry, and it requires new training and so forth, I was disappointed that the conferees rejected the Senate passed provision to allow those benefits to continue.

It seems to me that those educational benefits provided by the employers often helped the lowest level employees the most, and those benefits give those employees a chance to move up the ladder, and it helps in their efforts for upward mobility. Do you think that that was a mistake?

Mr. CHAPOTON. Senator Symms, I think Senator Packwood would disagree with me on this, but no, I do not think that was a mistake. I think that is the type of benefit that we should not encourage through tax exemption. I think we should encourage it. It is certainly very desirable, but I think within the tax system we keep trying to effect behavior in matters such as that, and we obviously undermine the tax base. We undermine the social security trust funds. And we again benefit—we give the benefit to some people, and we would never do it if we were just giving a direct Government benefit. Clearly, a case can be made, and I know the point you just made that it would benefit some lower paid employees, and I think the case is also made that, absent of the tax exclusion, they wouldn't be provided the educational benefit. I am not ever sure why that is the case. I am not sure why the employer cannot say I am going to come over here and pay that for you. I pay it for you as additional compensation and you are going to have to pay a little tax on it, but it is still better than if I hadn't paid it at all and encourage the employee in that way. But when we start with the tax system deciding that this type of compensation is better and we want employers to do this, then I think we have got to be very careful.

Senator SYMMS. I appreciate your point of view on that, Buck, but Bob Packwood had a bill introduced on it, and I would either encourage him to reintroduce it or I would like to introduce the bill right away to reinstate that tax status because it appears to me that here we are passing legislation in Washington to put more money in math-science because we say we need higher tech trained people and to retrain unemployed steel workers and so forth to be able to do other types of work, and it just seems like that is a tax-qualified benefit that really offers an opportunity for upward mobility.

I kind of agree with Senator Packwood in a more general sense that I am reluctant to have the Government get involved in every aspect of the savings plans, the profit-sharing plans, the pension plans, revenue raising. What I fear is not so much from the standpoint of the social engineering of it, but I am afraid that what some people are trying to do is simply raise revenue by going after tax benefits when we really need to be looking at the spending side more.

It is a little bit like you said—on one hand we are concerned about the budget, and we all are, and on the other hand, we are trying to provide benefits for certain things, but the essence of it is with some of these services, like education or health benefits that we do think have a positive impact on society, what is the most efficient way to provide those services—through the private sector or the Government sector? I just feel like the Government's record is not as good as the private sector's for efficiency and fair distribution of those same services.

So, I will look forward to hearing what all of our witnesses are going to have to say, and I look forward to—and in fact, I am like Bob Packwood, in that although I disagree with you on a few of these issues, I am glad to know that you are just going to go downtown and be right here with us in Washington. I look forward to—as soon as this happens—I will bet that Buck will be on the same side of more issues than he is right now with me. [Laughter.]

Senator PACKWOOD. I have a feeling he may be retained by a few clients who have a different view than the one we are talking about right now.

Senator SYMMS. I will tell you one thing about it. He is going to be a lot more equitably compensated than he is now. [Laughter.]

Mr. CHAPOTON. Senator Symms, besides all that, let me just point out that your point that the Government cannot do it efficiently—I think that point is often made and is certainly a valid point. I just would point out that a lot of people fail to recognize that when we do something—educational benefits are one of them—that Government is becoming involved. Government is deciding that we want more of our resources in that direction, and you are saying we are willing to pay a cost. We are willing to pay a Government cost to do that.

Senator SYMMS. You are right. It encourages allocation.

Mr. CHAPOTON. Yes; government is not neutral.

Senator SYMMS. It would be more ideal if we had a taxing system with a complete new look to it, but in the meantime, sometimes I find it difficult to see us on one hand, we are being pressured to vote for more funds—for example, the most recent passage of the math-science bill—and then, we will turn right around and say but if somebody is going to send somebody off here to school to learn how to be more efficient and proficient in the operation of computers and mathematics and so forth, that we are going to make them be taxed on those benefits. It is kind of like one side saying one thing, and one saying the other thing. That is what bothers me, and that is why I would like to take another look at that issue and see what this committee would like to do with that. I am not so sure that we really shouldn't relook it. If some of these other issues are open, maybe we ought to look at that one, too. That is all I would like to say and at least get that bill before this committee so we could talk about it. But thank you, and I see the chairman is here.

Senator DOLE. I didn't hear Buck's statement.

Senator SYMMS. It was outstanding, as usual.

Senator DOLE. But it does show some restraint, and we are getting things underway here. We always get a good crowd. I notice we have people in the hallway and people in the other room, and this room is filled. Everybody wants to drain the Treasury, and I can get blamed for raising taxes.

I get a little saddle-sore from that from time to time. Symms votes against the taxes, but he wants to give it away. So, I have a statement to put in the record, and I think this is an outstanding hearing. There are several witnesses, and maybe we can come up with some reasonable across-the-board policy. Did the Treasury have any figure on what the revenue loss of all these various benefits?

Mr. CHAPOTON. You would probably look at the tax expenditure table. We do have some figures in the testimony on the growth of the percentage of compensation paid through statutory nonfringe benefits, but you can add it up different ways. I guess the best way is to look at the tax expenditure table and get a rough estimate.

Obviously, the two big ones are health insurance and qualified plans, both of which I think nobody is talking about dramatically cutting back on, but we ought to be worried—particularly in the health care—about increase in the benefits.

Senator DOLE. I don't know where we are going to end up here, but obviously, we are not going to be taking any action this year. I hope we aren't going to drag up any bills that didn't make it in conference because there are 500 people who want to put a little tax bill together, and I am not one of them. So, I just hope we have seen our last tax bill this year. Maybe if Mondale is elected, we could rush through one after the election. [Laughter.]

Senator DOLE. But I think we just ought to give him the tax trophy, and move on. He does want to raise taxes. Most of us don't. But we don't want to be forced to raise taxes by losing a lot of money through the back door and then forcing us to raise taxes in some other place. I know some aren't concerned about that. Some would replace the revenue losses that we lose through the fringe area with a consumption tax or whatever, but we haven't reached that point yet. I would hope there would be some restraint,

Finally, I want to thank you, Buck. Is this your last committee appearance?

Mr. CHAPOTON. Yes, sir.

Senator DOLE. Hopefully?

Mr. CHAPOTON. Hopefully. [Laughter.]

Senator DOLE. You have done an outstanding job, and we appreciate it. I know the many people you have helped and many you have shafted appreciate it. [Laughter.]

Senator DOLE. I think you have been objective and fair, and that is the important thing. It has really been a privilege for our committee and the committee staff to work with you and your people at Treasury.

Mr. CHAPOTON. Thank you very much, Mr. Chairman. It has been my pleasure.

Senator PACKWOOD. We will look forward to seeing you back here in another capacity.

Mr. CHAPOTON. OK. Thank you, Senator Packwood.

Senator PACKWOOD. Thank you, Buck. Good luck.

Mr. CHAPOTON. Thank you.

Senator PACKWOOD. Now we will move on to Bob Georgine, who is going to show us how a witness can go through his statement in 5 minutes. [Laughter.]

Senator PACKWOOD. Bob Georgine is president of the Building and Construction Trades of the AFL-CIO but appearing here as the chairman of the National Coordinating Committee for Multiemployer Plans. This committee has worked with that group and Bob on a variety of issues involving multiemployer pension plans. Go right ahead.

STATEMENT OF ROBERT GEORGINE, PRESIDENT, BUILDING & CONSTRUCTION TRADES, AFL-CIO, WASHINGTON, DC, ON BEHALF OF THE NATIONAL COORDINATING COMMITTEE, MULTIEMPLOYER PLANS, WASHINGTON, DC.

Mr. GEORGINE. I will read fast, Mr. chairman. I am Bob Georgine, and I am chairman of the National Coordinating Committee for Multiemployer Plans, which is an organization that represents the interests of more than 8 million working men and women and their families who are covered by multiemployer plans. The NCCMP and its affiliates are deeply concerned about the continuing viability of collectively bargained employee benefit plans. These plans provide a wide range of essential benefits to workers who generally could not otherwise afford them, and thus serve a number of important public policies.

Nonetheless, a disturbing trend appears to be developing to curtail the Federal tax incentives that have played a key role in the development of such benefit funds. Several factors appear responsible. First, the continuing Federal deficits have created intense revenue pressures. Reducing the taxpayer status of employee benefits appeals to some as a low visibility way to generate additional revenues. In our view, however, the Nation cannot justify any attempt to balance the Federal budget on the backs of the working men and women of this country. Our workers and their families depend on the retirement, the health care, the disability, the life and unemployment insurance benefits provided by these plans. More equitable and humane ways of raising revenue exist than curtailing or eliminating these benefits.

Moreover, cutbacks in privately funded benefits will certainly result in new revenue pressures on federally funded or assisted programs. A second reason for the restrictive legislative trend may be the instances of reported abuse. I am given the example of doctors and other professionals arranging for yachts to be contributed to a purported benefit plan. To the extent that such abuses actually exist, the Coordinating Committee has no interest in protecting them.

However, we believe that actual abuses must first be identified and that any remedy must be carefully tailored in order to excise only the abuse situation. Abuse surgery that cuts deeply into the healthy tissue, for example, the recent VEBA legislation, has already worked unnecessary and unfair hardship on participants in the legitimate benefit plans.

In this connection, we are aware of no abuse in collectively bargained plans and no such abuse has been reported. It has long been established that the very nature of the collective bargaining process where the employer and the employee have a healthy adversity of economic interests precludes the kinds of abuses that may exist elsewhere.

Apparent abuses in one sector should not be used as a smokescreen for revenue-motivated cuts in a nonabusive area. In this regard, we note that the House and Senate Labor Committees have a familiarity and an expertise on collective bargaining issues that is not shared by all members of the tax-writing committees. We believe that their effective exclusion from the legislative consideration of these issues has produced many unfortunate results and should not continue.

The third rationale sometimes advanced for restrictions—for example, the proposed tax cap on health care benefits—is supposedly grounded in principles of efficiency and cost containment. Extend the incentive to a flat dollar amount, the theory goes, and actual health care costs will magically shrink to stay within the limits. This is, of course, a pure pipedream. The actual result would be the taxation of medical benefits for many middle- and low-income workers. In this respect, cost containment is nothing more than a pleasant euphenism for the imposition of taxes on health care benefit programs. Moreover, the efficiency and cost containment arguments generally have ignored the essential substantial historical contributions of collectively bargained plans in these areas. These plans pioneered experimentation with health care delivery systems such as HMO's, designed to provide care efficiently and at a low cost.

Mr. Chairman, the 73 million workers covered under health insurance plans represent a substantial constituency that must be taken into account. The taxation of benefit programs may well constitute a low visibility no-constituency issue at the present time. Plan participants tend to take these benefits for granted. Our experience, has been, however, that when a change actually takes effect, participants become very vocal. And I expect, Mr. Chairman, that you have observed this phenomenon yourself.

In closing, our fundamental belief is that the private sector plays an essential role and is more efficient and cost effective than Government programs in providing health care and other essential benefits. The relatively modest tax incentives set forth in current law are an essential element to the viability of the private benefit systems as currently in effect. We look forward to the continuation of the collective bargaining process of the health, welfare and retirement benefits on which our members so strongly depend.

Thank you, Mr. Chairman.

Senator PACKWOOD. Very good.

Mr. GEORGINE. Did I make it in 5 minutes?

Senator PACKWOOD. You made it in 5 minutes.

[Mr. Georgine's prepared statement follows:]

National Coordinating Committee for Multiemployer Plans

SUITE 603 • 815 SIXTEENTH STREET, N.W., WASHINGTON, D.C. 20006 • (202) 347-1461

Statement of

ROBERT A. GEORGINE,

Chairman of the National Coordinating
Committee for Multiemployer Plans

Before the

Taxation & Debt Management Subcommittee
of the
Senate Finance Committee

July 26, 1984

My name is Robert A. Georgine, and I appear here today in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee was organized, shortly after the passage of ERISA in 1974, in order to represent the interests of the more than eight million working men and women, and their families, who are covered by multiemployer plans. The Committee's affiliates include more than 140 pension funds, health and welfare funds, and related international unions.

Mr. Chairman, the NCCMP and its affiliates are deeply concerned about the continuing viability of collectively bargained employee benefit plans. These plans provide a wide range of essential benefits to workers who generally could not otherwise afford them, and thus serve a number of important public policies.

Nonetheless, a disturbing trend appears to be developing to curtail the federal tax incentives that have played a key role in the development of such benefit funds. Most recently, the Deficit Reduction Act of 1984 imposed new limits on contribution deductibility and subjected the earnings of employee benefit funds to new taxes on so-called unrelated business taxable income. That Act also repealed the estate tax exclusion for benefits paid from pension plans. Before that, the TEFRA legislation subjected pension benefits to withholding taxes and imposed other restrictions and burdens on employee benefit plans. There have been several major efforts, so far unsuccessful, to impose a "cap" on health care deductions or, alternatively, to include a portion of an employer's payments for health care in the income of the beneficiary. Numerous other examples might be cited to illustrate this trend.

Several factors appear responsible. First, the continuing federal deficits have created intense revenue pressures. Reducing the tax-favored status of employee benefits appeals to some as a low-visibility way to generate additional revenues. In our view, however, this nation cannot justify any attempt to balance the federal budget on the backs of the working men and women of this country. Our workers and their families depend on the retirement, health care, disability, life and unemployment insurance benefits provided by these plans. More equitable and humane ways of raising revenue exist than curtailing or eliminating these benefits.

Moreover, attempting to raise revenues in this manner is likely to be counterproductive. The curtailment of supplementary unemployment benefits, for example, would likely impose substantial additional pressures on federally funded or assisted welfare and unemployment programs. Cutbacks in the provision of pension benefits would create even more obvious participant needs. The loss of such benefits would also likely result in significant grassroots pressure for new programs involving direct federal spending. Existing federal tax incentives provide an efficient cost-effective incentive for the provision of these essential benefits by the private sector. Substantial curtailment of these incentives would represent short-sighted and ineffective economic planning.

A second reason for the restrictive legislative trend may be the instances of reported abuse -- for example, doctors and other professionals arranging for yachts to be contributed to a purported benefit plan. To the extent such abuses actually exist, the Coordinating Committee has no interest in protecting them. However, we believe that actual abuses must first be identified, and that any remedy must be carefully tailored in order to excise only the abuse situation. Abuse surgery that cuts deeply into healthy tissue, for example the recent VEBA legislation, has already worked unnecessary and unfair hardship on participants in legitimate benefit plans.

In this connection, we are aware of no abuse in collectively bargained plans, and no such abuse has been reported. It has long been established that the very nature of the collective bargaining process -- where the employer and the employee have a healthy adversity of economic interest -- precludes the kinds of abuses that may exist elsewhere. All other things being equal, an employer's economic interest does not lie in making excessive contributions to employee benefit plans. While contributions are in the employee's interest, employees generally want contributions limited to what is necessary to fund the benefit involved. A dollar in additional employer contribution generally means a dollar less in wages. Moreover, multiemployer plans are jointly trusteed, so that this healthy adversity is reflected in the administration of such plans. Finally, collectively bargained plans do not selectively provide benefits to owners or highly compensated individuals, thereby posing discrimination problems, as is generally recognized by the anti-discrimination provisions of the Internal Revenue Code.

Thus, in our view, the perception of abuse or abuse potential offers no justification for new restrictions, tax or otherwise, on collectively bargained benefit plans. Apparent abuses in one sector should not be used as a smokescreen for revenue-motivated cuts in a nonabusive area. In this regard, we note that the House and Senate Labor committees have a familiarity and expertise on collective bargaining issues that is not shared by all members of the tax-writing committees. We believe that their effective exclusion from the legislative consideration of these issues has produced many unfortunate results, and should not continue.

A third rationale sometimes advanced for restrictions -- for example the proposed "tax cap" on health care benefits -- is supposedly grounded in principles of efficiency and cost containment. Extend the incentive to a flat dollar amount, the theory goes, and actual health care costs will magically shrink to stay within the limits. Lower health care costs would benefit everyone (except perhaps the health care providers), and important social policy and federal revenue considerations would thereby be served.

This is, of course, pure pipe dream. The actual result would be the taxation of medical benefits for many middle- and low-income workers. Had the $175 per month "cap" proposed last year actually been adopted, one study conservatively estimates the following:

35 percent of the union-represented employees covered by multiemployer plans would have been subject to an average of $145 per year in additional tax. Some employees in the study would have owed nearly $500 in additional tax. In this respect, "cost containment" is nothing more than a pleasant euphemism for the imposition of taxes on health care benefits programs.

Moreover, the efficiency and cost-containment arguments have generally ignored the substantial, historical contributions of collectively bargained plans in these areas. Such plans pioneered experimentation with health care delivery systems designed to provide care efficiently and at low cost. These plans were among the first to utilize Health Maintenance Organizations, second opinions on the necessity for surgery, and dental clinics. This experimentation has continued outside the health care arena, as our plans' experience with legal services programs amply demonstrates.

In summary, then, the Coordinating Committee believes that any reappraisal of the tax incentives presently afforded to employee benefit plans should not lose sight of the central facts. First, such plans -- particularly collectively bargained plans -- have proven to be overwhelmingly successful arrangements for the private sector provision of essential benefits. Many of those for whom such benefits are provided have totally inadequate personal resources, and would otherwise fall back on the public sector. Efforts to improve on a system that is working so efficiently may well prove counterproductive.

Second, any so-called "reform" measures must be carefully directed, so as to cover only instances of actual abuse. Such measures should not result in restrictions on plans, like collectively bargained plans, where the perceived abuse cannot exist.

Finally, questions of revenue loss, efficiency and cost containment must be considered in the proper context. Historically, collectively bargained plans have been innovative leaders and experimenters in providing benefits efficiently and at low cost. Moreover, the "savings" from curtailment of tax incentives in this area may well be illusory, as plan participants will necessarily look to alternate sources -- primarily federally funded benefit programs.

Furthermore, the seventy-three million workers covered under health insurance plans represent a substantial constituency that must be taken into account. The taxation of benefit programs may well constitute a low-visibility/no-constituency issue as an initial matter. Plan participants tend to take these benefits for granted, and do not generally scrutinize the Daily Tax Reporter or other public accounts of proposed changes in this area. Our experience has been, however, that when the change actually takes effect, participants become very vocal. I expect, Mr. Chairman, that you have observed this phenomenon yourself.

In closing, Mr. Chairman, our fundamental belief is that the private sector plays an essential role, and is often more efficient and cost-effective than government programs, in providing health care and other essential benefits. The relatively modest tax incentives set forth in current law are an essential element to the viability of the private benefits system, as currently in effect. We look forward to the continuation, through the collective bargaining process, of the health, welfare and retirement benefits on which our members so strongly depend.

Thank you very much for the opportunity to make our views known.

Senator PACKWOOD. Let me ask you a question, or maybe Jack can answer because the one group of unions I did not bargain with extensively when I practiced was the building trades. The AGC was represented by another law firm, and they had most of the building trade contracts. Do you have—whether it is the laborers, the bricklayers, or otherwise—slightly different employee benefits depending upon the unions, in that some of them would have a greater preference for one than the other, or are they pretty much uniform throughout the trades?

Mr. CURRAN. They are pretty much uniform throughout the trades. There may be some slight differences, but they are very slight. And that goes not only for the construction unions, Mr. Chairman, that goes for all of the other unions. The uniformity of benefits is pretty consistent throughout the whole system.

Senator PACKWOOD. The reason I asked that is when Jack and I first got to know each other, it was over the prepaid legal issue, and at that time, the laborers had it but a lot of other unions did not, as I recall. Jack, isn't that correct?

Mr. CURRAN. That is correct, but that is because no one else was in it.

Senator PACKWOOD. Yes. As I recall, Jack, you got into it about 1973 or 1974. A couple of years later, the IRS was trying to tax the benefits, and that is when we first got together on attempting to examine that.

Mr. CURRAN. That is right, Mr. Chairman. That was our first association.

Senator PACKWOOD. Bob?

Senator DOLE. I have no questions.

Senator PACKWOOD. You are looking very good, Bob. Congratulations.

Mr. GEORGINE. Thank you. I am glad I had a benefit plan to pay for my recent surgery, I will tell you that.

Senator PACKWOOD. There is a very good example. Could you have paid for that yourself if you had not had a benefit plan?

Mr. GEORGINE. No way; no way. We are talking about $30,000 worth of medical fees. No way I could have paid.

Senator PACKWOOD. Fellows, thank you very much.

Senator DOLE. Could I just ask a question? You indicated that the VEBA legislation has resulted in some rather drastic hardships. Could you provide the committee some examples, so we can look at those areas.

Mr. GEORGINE. We are going to do that, Senator Dole. You know, recently they had a convention of that other party.

Senator DOLE. Yes; I read about it. [Laughter.]

Mr. GEORGINE. That has tied up a couple weeks of our time, but we have——

Senator DOLE. If you have time, though, you might hit some paydirt in Dallas.

Mr. GEORGINE. We do have some examples that we want to show you and that we want to talk over with you.

Senator PACKWOOD. As long as you are talking about dividing time, I want to express appreciation for dividing the time that you did in the past as far as my races have been concerned. I won't forget it.

Mr. GEORGINE. Thank you, Senator.

Senator PACKWOOD. I look forward to it in the future, hopefully.

Mr. GEORGINE. We will be there.

Senator PACKWOOD. Thank you. Next, we will have a panel.

Mr. GEORGINE. Mr. Chairman?

Senator PACKWOOD. Yes?

Mr. GEORGINE. I didn't say at the outset that we do have a longer, detailed prepared statement that we would like to have included in the record.

Senator PACKWOOD. Every statement in its entirety will be included in the record. I realize that there are not going to be many Senators at all these hearings. I don't think there is going to be much action the rest of the year, one way or the other, but when we get into this next year, I want to have as full a record as possible of the broad reach of these benefits and how many average, middle-income employee are covered with legitimate benefits.

By the time we are done with these 3 days, we are going to have that record.

Mr. GEORGINE. Thank you again, Mr. Chairman, and thank you, Senator Dole.

Senator PACKWOOD. Thank you. Next, let's take Ed Davey, who is the executive director and general counsel of the Association of Private Pension and Welfare Plans, and Frederick Hunt, representing the Society of Professional Benefit Administrators.

Fellows, go right ahead and follow Bob's example.

STATEMENT OF EDWARD J. DAVEY, EXECUTIVE DIRECTOR AND GENERAL COUNSEL, THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS (APPWP), WASHINGTON, DC

Mr. DAVEY. Mr. Chairman, I want to thank you for inviting us to appear at the hearing, and I want to commend you at the outset for taking such a leadership role and continuing to have such an interest in this area. We need some friends on the Hill in this area, and we appreciate that.

I would like to digress a minute from my statement to talk about the figure that was bantied around by Mr. Chapoton and Senator Chafee of 32 percent of wages and salaries going toward fringe benefits. I think we can agree on that figure because that is a figure that most of us are agreeing on, but I think you have to go beyond that number and break it down. This is extremely important.

Senator PACKWOOD. That includes Social Security, as I recall.

Mr. DAVEY. Exactly. It includes legal required payments by employers, which is about 9.5 percent. Then you have discretionary payments by employers for paid vacations, sick leave, time off for lunch—which is about 13.5 percent.

Senator PACKWOOD. How much?

Mr. DAVEY. About 13.5 percent. Then, the next piece, which is what we call tax-favored benefits, you have about 9 percent, but I think you have to break that 9 percent figure down into two categories, and those two categories would be tax-deferred which amounts to about 4 percent. When we are saying tax-deferred benefits, we are saying eventually, that is under a pension plan or profit-sharing plan, that will come out from the plan and be taxed later on, and that the Government will recover a significant portion of that money, upwards of 75 percent.

The last area, what we call tax-exempt benefits. This amounts to about 4.6 percent. Here we are talking about such items as group health insurance, child care, employee discounts. This is the only revenue that is lost to the Treasury.

Senator PACKWOOD. Health being the overwhelmingly biggest part of that 4.6 percent.

Mr. DAVEY. Absolutely. I think what we are really talking about now is a piece of that 32 percent of approximately 4.6 percent. This is the significant number. We ought to set the record straight on what is the correct figure.

The second point that I would like to make is that we have had in the last 10 years five major tax bills that have dealt with employee benefits. For many of us in the industry, we need to catch our breath. First of all, we need to find out what the changes are, particularly in the last 2 or 3 years. Second, and more importantly, I think what we are groping for is for Congress to develop a national policy with respect to the private sector and tell us what it is you want us to provide and how should we provide it. Third, how should these private programs interrelate with public programs like Social Security, medicare, etc. I think that if these hearings accomplish anything, guidance in this area would be extraordinarily helpful to us. And the last point that I would like to make is that I think one of the concerns that we have—and I think, Senator Packwood, you mentioned this briefly—is that we are concerned about the growing trend to encourage individual arrangements rather than employer-sponsored benefit plans. I think it was precisely the experience of the depression that prompted Congress not only to enact Social Security legislation but to begin to provide incentives for employer-sponsored programs. And I think that is what the debate is going be about. Should we go the individual route or should we go employer or the group sponsored route.

Senator PACKWOOD. I don't think that will ultimately be the debate because I think you are going to end up with Government provided benefits if you don't go the employer route. I cannot imagine that the history of this country will be any different than most other democracies. If there is no employer-provided health insurance or day care or the normal range of what people regard as legitimate benefits the Government is going to provide them. The demand will be there. The votes will be there. We will do it ineptly and badly and expensively and tax the employers—to pay for it, and it will cost the employers more than providing it themselves.

Mr. DAVEY. And the one last point that I would like to make is that our other concern is that we seem to be moving in the direction of making policy in this area based on the concept of the time value of money. I think our concern in this area is best expressed in what happened in the last go-around on VEBA's, and particularly in the post-retirement medical area. I don't think many members realize that we are now going to tax the trust for post-retirement medical, and that is a very, very significant precedent. If that represents a policy shift, I think we ought to be cognizant of that. Are we going to move into other areas and tax the trust that employers are now providing for other benefits? I think that is very important.

Senator PACKWOOD. Mr. Hunt?

[Mr. Davey's prepared statement follows:]

STATEMENT

OF THE

ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

BEFORE

THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

July 26, 1984

Mr. Chairman and Members of the Subcommittee: I am Edward J. Davey, Executive Director and General Counsel of the Association of Private Pension and Welfare Plans (APPWP).

I am pleased to be able to appear before you to testify on behalf of the APPWP. Ours is a non-profit organization, founded in 1967 with the primary goal of providing and fostering the growth of this country's private employee benefits system. The Association represents over 500 organizations across the United States: both large and small employers who sponsor plans and leading support organizations to private plans including banks, insurance companies, accounting firms, and actuarial and consulting firms. Collectively, APPWP's membership is involved directly with the vast majority of employee benefit plans maintained by the private sector. Currently, the health insurance programs of U.S. businesses cover over 75% of American workers. The pension programs of these employers, for people in their 40's today, will provide pensions to 82% of married couples and 58% of unmarried individuals. It is easy to discern from these statistics that these programs are of great benefit to low and middle income workers.

We commend you, Mr. Chairman for your leadership on employee benefit issues and your continuing concerns in this area. We are hopeful that we can all take advantage of this opportunity to step back from the legislative activity of the past months and consider the long term effects of the changes that have been made over the last several years in the area of employee benefits. Only from such an inquiry and analysis can we effectively address the future of the private benefit system.

The approach to welfare and pension benefits in this country has, for many years, been fragmented and inconsistent. Changes are made piecemeal, and in rapid succession, without opportunity to assess how any individual changes will affect the provision of benefits to employees. In the ten years since enactment of ERISA, we have seen 5 major pieces of tax legislation dealing with welfare and pension benefits, a restructuring of the multi-employer defined benefit pension plan system, retirement equity bills and a proposal to restructure the single employer termination insurance program. While much of the change has been motivated by concerns about the level of the federal deficit, the scope of benefit coverage, and the future of Social Security, much of the criticism of the system is based on sketchy and incomplete data, if based on fact at all.

A little over a year ago, Jacob Javits, one of the architects of the first major pension reform act, ERISA, testified that as of 1982, 75% of those individuals benefiting from defined benefit pension plans earned less than $50,000 and that the tax advantages of these programs benefitted more middle income individuals than the home mortgage deduction. He cautioned against too speedy an indictment of the private pension system in this country for failure to serve a broad cross-section of employees. In his view, we should be taking steps now to encourage the health and growth of advance-funded arrangements. As he pointed out, "it is none too soon to start amassing the kind of assets we will need for the 'baby-boom's' retirement."

The Association wholeheartedly agrees. A recent study by the Employee Benefit Research Institute reveals that of the over 80 million nonagricultural employees in the United States, over 47 million, or 59%, are covered by retirement plans, including more than 37% of employees earning less than $10,000, more than 57% of those earning between $10,000 and $15,000 and almost 72% of those earning between $15,000 and $20,000. The statistics on group health coverage are even more impressive. Of the over 15 million employees earning $5,000 - $10,000, almost half were covered by group health arrangements on their current jobs. Of the almost 18 million employees earning between $10,000 and $15,000, more than two-thirds were covered. In higher wage brackets, coverage ranges from more than 80% to nearly full coverage. In the face of these statistics, it is indeed difficult to maintain that employers provide statutory benefits only to the highly paid. There is simply no factual basis for these arguments.

Nor is there any substance to the argument that benefits are provided by an employer solely to shelter income. Provision of health care, life insurance and retirement programs are enormous employee incentives. Unquestionably, they promote a happier, more secure, more productive workforce, which in turn, enhances an employer's competitive position in attracting and maintaining good employees. Especially at the lower wage levels, adequate health coverage and other statutory benefits such as child care facilities, legal services, educational assistance and disability insurance vastly improve employee morale, attendance, and productivity.

While the federal deficit and erosion of the tax base must be of concern to all of us, it would be a grave mistake to act on the erroneous assumption that all employee benefits are forever lost to the tax base, or to disregard the social policy reasons for those tax-preferred arrangements. We fundamentally disagree with those who see employee benefit coverage largely as a tax issue, to be tinkered and experimented with through repeated amendments to the tax code. The Association believes that the benefits debate should not be conducted exclusively in the forum provided by the Treasury and the tax-writing committees. The type and level of benefits provided by employers is a critical social issue that should not be driven solely by its revenue implications. We would be making a serious mistake if the discussion of how employee benefits can most effectively and efficiently be provided in this country is carried on only in the context of perceived tax shelter abuses.

It is the private sector that has provided the most comprehensive employee benefit package available to employees, and there is no evidence that the government could run these

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programs as efficiently as they are run in the private sector, or that the government would be prepared to assume the costs attendant to doing so. Not only is the package comprehensive, but it has developed into a flexible and need-directed program that best serves the individual requirements of employees at different stages of their lives. Moreover, in a period when the level and availability of government provided benefits is increasingly in doubt and increasingly costly, the need for the continued existence and expansion of the private benefit program cannot be overstated. As the baby boom generation nears retirement, the ability of the social security system to deliver at manageable cost levels will be stretched to its limits. By the year 2020, the percentage of those over age 65 will increase from 11 to 16 percent. The number of individuals over age 85 will increase 79 percent by 1995. These statistics graphically demonstrate the enormous burdens that will be put on the social security system, a system which already relies on pay-as-you-go financing. As our demographic balance changes, the system will be even more vulnerable to declining economic conditions because with the retirement of the baby boom generation, the number of active workers supporting retired beneficiaries will decrease by almost half.

The social security system is also widely considered inadequate at middle or upper income levels. Currently, an average worker who retired in 1981 receives a benefit roughly equivalent to 47% of his pre-retirement earnings, although to replace his preretirement standard of living, he would need a

68% replacement rate. While the system is targeted to replace 42% of average pre-retirement earnings, the fact that it is skewed toward the lower paid results in a 61% replacement rate for employees earning the minimum wage and less than a 28% replacement rate for employees earning $30,000 or more. Thus, even if the system were financially sound, it does not provide, across the board, the kind of retirement income security that the private system, in conjunction with social security, has led employees to expect. It becomes, then, even more critical to support and expand the private benefit system, both to provide the kinds of coverage which the government system does not provide, and to bridge the income gap between social security and an adequate retirement income.

By the same token, the integration rules must be reconsidered, so that the correlation of private pension benefit formulas with social security provides incentives to cover both lower paid and highly paid employees within the same structure. This can be achieved by allowing benefits to be proportional to pay. The current rules are complex and difficult to understand and administer. New rules should be considered which are simple and durable. We believe that a 50% offset of a participant's social security benefit would provide such a formula.

We are also concerned about the growing trend in recent tax legislation to encourage individual arrangements rather than employer-sponsored group benefit plans. This trend is reflected in the additional incentives for individual retirement accounts and the reduction of tax incentives related to employer-sponsored funded welfare plans and pension plan contribution and benefit levels. It is revealing that 75% of pension coverage benefits employees earning under $20,000 annually. In contrast, 18% of all IRA accounts are maintained by households with adjusted gross incomes of less than $20,000. Employee controlled and initiated benefit arrangements shift the responsibility for saving, and the risk for not saving, to employees. Instead of an employer assurance that employees will be treated equitably in terms of their health care, their provision for dependents at death, and their retirement income, the movement toward employee assumption of the risk and responsibility for these benefits may well create a disparity of treatment among individuals, depending on their individual foresight and/or anxiety about the future. Similarly, an employee's ultimate retirement income will depend on the state of the financial and stock markets at the time of retirement. While it may be that coverage and the level of benefits will remain constant, despite the shift in the sponsorship of benefits from employer to employee, it may also be that severe economic conditions in the future could result in wiping-out of health, disability and retirement protection, similar to this country's experience in the 1930's, when individual arrangements failed.

It was precisely the experience of the Depression that prompted Congress not only to enact social security legislation, but to begin to provide incentives for employer-sponsored arrangements, and then to increasingly require better and faster funding of those arrangements, with tax incentives for doing so. We now seem to be moving in the opposite direction. The swing in favor of a revenue philosophy based on the time value of money significantly alters the past trend toward employer-sponsored, well-funded arrangements. In the short run, it may increase the flow of revenue into the Treasury; however, in the long run, it encourages employers to reanalyze whether funds should be retained at the corporate level, increasing current pay to employees instead of contributing to funded deferred arrangements. An example can be seen in the recent tax changes which make post-retirement medical care funds taxable. A trend toward making other benefit trusts taxable would surely be a disincentive to employers to continue contributions, knowing that the earnings on their contributions will be taxed, requiring greater contributions to maintain the same level of benefits, or in the absence of increased contributions, reduction in these benefits.

This approach may have unintended consequences on the deficit in two ways. First, the lack of tax incentives and concomitant denial to employers of the use of money may reduce the working capital of American business, forcing it into the capital markets for borrowing in competition with the federal government, thereby generally raising the rate at which everyone can borrow. That result is not only less efficient for business, but it also results in increasing, rather than decreasing the deficit, as was intended by the recent tax changes. Secondly, if employers move toward increasing current wages rather than funding deferred arrangements, and either the confidence in employees to voluntarily save is misplaced, or the level of coverage is decreased due to the higher costs of individual arrangements, the long term result may be greater government involvement in, and administration and control of, mandatory employee benefit levels. Eventually, these will be financed out of tax revenues. Thus, directly contrary to Congress' intent, the deficit will be increased in years to come.

In summary, the Association strongly supports a reexamination of the future of employee benefits. However, we believe that any consideration of these issues must include an awareness of the social policy risks inherent in the recent direction of tax legislative changes, and not only their revenue implications. We must analyze very carefully who can best provide employee benefits in the most cost-efficient manner that will reasonably result in adequate, fair, and predictable treatment for employees.

STATEMENT OF FREDERICK D. HUNT, JR., EXECUTIVE DIRECTOR, THE SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS, WASHINGTON, DC

Mr. HUNT. As you say, Senator, my name is Fred Hunt. I am executive director of the Society of Professional Benefit Administrators, more conveniently known as SPBA. Ulike a lot of the other groups, we are not a household word, so let me take a couple of seconds to explain that we are probably one of the most comprehensive voices in employee benefits. About a third of all U.S. workers, retirees, and dependents from every type and size of employment situation is covered by our independent third-party administration firms. Most use VEBA's, and I suspect that since our membership has grown 500 percent in the last 4 years, a lot of those extra VEBA's that Buck Chapoton was talking about can probably be traced to us.

However, the other day I got a call from one of the trade press who asked if I could give a one-sentence description of the situation of employee benefits and tax policy today. I said that if Uncle Sam does not get his act together and stop his schizophrenic tinkering with employee benefits, about 200 million Americans will suffer irreparable social and financial harm, including serious damage to Government revenues. Now, those are strong words, but I think they accurately, though perhaps too candidly, reflect the position that employee benefits find themselves in today as a scapegoat in a political football among the 70 or so Government agencies and a seemingly equal number of congressional offices which have rules, desires, and often they are conflicting goals. Half of them say, "you ought to have more benefits." Half of them say, "no, you are spending too much—you ought to have fewer benefits." We are caught in the middle of that.

And as Ed (Davey) says, there is no national policy, which I think is a real shame. Now, your question in this hearing was whether tax policy should encourage employee benefits, I should point out that every Congress and every administration—no matter what party . . . in this century—has said an absolute yes. One of the best examples happened just a week or so ago. Senator Chafee put in a bill which would have mandated preventive child care for children. A very nice, desirable social goal, but then, here he is on this committee, which often picks on employee benefits, saying you ought to be doing this or that . . . but where is the money going to come from? I did happen to pick on him because he is not here, but that is a recent example right now.

Senator PACKWOOD. What did his bill do?

Mr. HUNT. His bill would have said that a plan could not have the tax deduction unless it included preventive health care for children. I just used it because it is recent. It is a desirable social goal.

One of the other things I should point out is that the Government has always mandated benefits when the Government has not felt that they were being provided or that they were not broad enough, such as, Social Security, medicare, and so forth It goes on and on.

The other thing is that the Government, as an employer, is one of the most exotic employee benefit arenas. When I think of my own example in the Army, by the time I got tax-free payments for housing, food, clothes, transportation, and Lord knows what else, I remember I was always amazed that I made more in tax-free benefits income than I did in what I was getting paid in the Army salary. And I am now, for the rest of my life, covered by the Veterans Administration, which to me is an employee benefit based on my employment in the Army. If you are going to cut things, cut the Veterans Administration as well.

In all of the talk of taxing benefits, the Treasury and congressional tax staff have had tunnel vision. I think that is one of my real concerns, and I know you had mentioned it once, Senator, that they are only looking at plans paid and operated from private funds, which is very incomplete. In running our office for SPBA, I happen to be a small businessman. I am the guy who writes the checks, and there is not a month that goes by when I don't have to be signing a check for some kind of Government-mandated or Government-run or quasi-Government-run employee benefit—social security, unemployment compensation, workers compensation etc. All of these are not run by an insurance company. Those are ones that were imposed by Uncle Sam, and if you are talking about a tax cap, if you are talking about elimination, you had better be cutting those as well. The other thing is, as Ed (Davey) has shown, statistics are very unreliable. You opened this hearing by saying that there is a shopping list, and I noticed that 2 weeks ago the "revenue loss" from employee benefits was $50 billion. Then magically, they are suddenly talking about $100 billion. I can't think that that really happened overnight. Someone is creating statistics to support their own goals.

The other thing is that the Government benefits, such as Social Security, are not really free. Though they seem to be paid for by the employer and employee with fully-taxed dollars in the case of the employee, they are actually—the operations for all of the Government programs—are paid by direct Government revenue. So, that is not free. We are paying double for that, and as you said, I suspect we are paying more.

Finally, and most importantly, there is such a churning of laws. It has created a vicious cycle. There is the excuse that there is an abuse, so we are going to settle the abuse. The "solution" creates more abuses, and so on and so forth. And I think that has just got to stop. Thank you, Senator.

[Mr. Hunt's prepared statement follows:]

SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
2033 M Street, NW • Suite 605 • Washington, D.C. 20036 • (202) 223-6413

OUTLINE OF ORAL (AND WRITTEN) TESTIMONY OF THE
SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
BY SPBA EXECUTIVE DIRECTOR FREDERICK D. HUNT, JR.
BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT
JULY 26, 27, & 30TH, 1984

The SPBA testimony will simply give direct candid answers to the questions outlined in the Finance Committee press release announcement of the hearings. In some cases, parts of more than one question have been combined and re-phrased for fewer, but more comprehesive, answers.

1. The current system of employee benefits is a small reflection of...and often mandated by...the Federal Government programs. The government has a consistent record of demanding or expanding benefits in the private sector, such as Workers Compensation in 1911, Social Security in 1935, etc. The political, financial, and logistical disasters which would emerge if the private employee benefit system were killed or crippled are unimaginable.

2. Unlike Government benefit programs, the private benefit plans have been designed and maintained to be stable, competitively cost-effective, and adequately funded. Benefits promised from any source are useless if the plan is broke.

3. The chaos caused by the government's constant churning of laws and policies creates (legal) "abuses", which then bring on more changes in the name of "reform", which allows more "abuses" etc. There is no national policy or goal for employee benefits, and there is no tax policy for benefits which lasts long enough to be evaluated.

4. Employers are trying to meet the modern changing needs of their workers. Thus, there is an attempt to adapt to two-worker families and avoid overlaps. If benefits (used and unused) were somehow taxed, the basic fabric of shared risk would be destroyed.... and massive costs absorbed by the Government.

5. A sad look into the crystal ball to forecast that government mis-management and harrassment will continue for several more years, until the Congress and the Treasury realize that they have very nearly killed the golden goose... at which time there will be a hurry and scurry on the part of the government to "save" the private employeee benefits.

SPBA SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
2033 M Street, NW • Suite 605 • Washington, D.C. 20036 • (202) 223-6413

Testimony of the
Society of Professional Benefit Administrators (SPBA)
to the
United States Senate Committee on Finance
Subcommittee on Taxation & Debt Management
July 26, 27, & 30th, 1984
by
Frederick D. Hunt, Jr., SPBA Executive Director

TAX POLICY AND EMPLOYEE BENEFITS

The Society of Professional Benefit Administrators (SPBA), founded in 1975, is the national association of independent third party contract benefit administration firms. It is estimated that one third (⅓) of all U.S. workers are covered by employee benefit plans administered by such firms.

SPBA members operate much like independent CPA or law firms...providing continuing professional out-of-house claims and benefit plan administration for client employers and benefit plans. Most of the plans employ at least some degree of self-funding. Client plans include those sponsored by corporations of all sizes, associations, and union/management jointly administered Taft Hartley multi-employer plans.

SPBA membership has been growing consistently at an annual rate of 100%...with a current roster of almost 275 member firms. Similarly, SPBA members have seen the market for their services also expand rapidly... in large part because of the leading role SPBA members have played in successful health cost containment efforts and cost-efficient administration techniques for pension and health benefit plans.

Mr. Chairman, the first question you raise in the announcement of the purpose of this hearing hits the nail on the head. You ask if the tax law should encourage employers to provide benefits, and if so, which, and what tax assistance is appropriate. The answer to the first part...should the government, though taxes encourage benefits...is an obvious YES. This is true, not only for the welfare of the people, but also for the economic efficiency and stability of the country.

The person who would most emphatically say that tax-assisted employee benefi s should be offered is Uncle Sam! In fact, everyone else in this hearing is only following the example and mandates of the Government.

page 2

The Federal Government not only has one of the most exotic arrays of employee benefits for its own workers...but every Congress and every President in this century have urged or created new employee benefits on private employers. Workers Compensation was mandated in 1911, Social Security in 1935, along with Unemployment Insurance. Those are just a few historical highlights. The mandated benefits since World War II are well known.

Further, virtually every session of Congress addresses some area of fairness or equality which also tends to expand existing benefits and costs. Private employers and the benefits industry are not against such equality. In fact, private plans have much less discrimination than Federal Government programs.

The point is that all of these created and expanded benefits are mandated employee benefits. Employers have little or no say about the costs or format. Most of the Government created or mandated benefits entail an extra tax cost. There are Federal or state bureaucracies fully supported by tax dollars to oversee such government-mandated benefits for private employees. The administrative overhead of the Social Security Administration is a good example. How many tax dollars are used for that and its dozens of sister agencies overseeing government-mandated benefits? I'm sure that those costs far exceed the $50 billion "revenue loss" for private benefit plans to provide more thorough and more stable benefits.

Thus, the answer to whether tax law should encourage employers to provide fringe benefits, and if so, which benefits and at what levels must start with Uncle Sam. I believe there is a phrase in the Bible which admonishes all of us to "Get thine own house in order". The Congress and President must ask themselves whether such programs as Workers Compensation, Social Security, Medicare, Medicaid, and Uninsurance Compensation be eliminated and/or made voluntary.

Conversely, some Senators and members of the Administration feel that there should be a tax on the employee for benefits or a "cap" on the value. That logic would seem to say that because I was in the Army, my W-2 should show a percentage of the millions of dollars it takes to run the Veterans Administration. The VA is an employee benefit to which I am theoretically eligible. Similarly, should the huge costs of running the Social Security and other government-mandate benefits agencies be divided up and appear on everyone's W-2 for tax purposes? I'm sure that everyone in Congress and the Administration would give an emphatic "NO" answer. Then why apply the same poor logic only to private employee benefits?

Those are the social and political reasons...but this is the Finance Committee, so let's look at the financial side. If the private employee benefit system were magically eliminated, the United States would face an economic disaster. The millions who are currently under cost-efficient private benefit plans would suddenly be dumped onto the roles of Social Security, Medicare, Medicaid, the Veterans Administration, and all of the other "safety net" benefits which the Federal Government has devised. Ironically, those government-sponsored plans are already in grave financial trouble...and are already taxing workers and employers to the maximum legal limits. Thus, they would be swamped with new claims, but not more income.

As the financial planners for the Congress, I think that the Senate Finance Committee would do well to consider the financial disaster and angry backlash or citizens if the private employee benefit system is not encouraged. YOU'RE GETTING A REAL BARGAIN! It is also a system that is more efficient and more popular with the people than the failing national socialized medicine programs that have been tried in Europe.

In answer to your questions about the effects of existing rules and tax incentives, I would say that there is complete chaos in and out of government. There are never any stable rules or understanding of the incentives. Neither the government nor the governed can keep up to date.

There have been hundreds of significant changes to employee benefits laws and regulations every year, spurred on by a major overhaul every Congress. For instance, before the ink of TEFRA was even dry, the Congress was off and running on a further major change, which has emerged as the Tax Reform Act of 1984. That isn't even printed yet, and we are being told that there will be significant changes to the changes next year in maybe as many as two major tax bills. Frankly, this causes confusion, errors, and a vicious cycle of what is called "abuse". Some citizens are so concerned about the government-caused instability (and/or they may also be greedy), that they adopt a policy of trying to secure their future now. Because of the constant churning and changing of laws inevitably leaves loopholes, these people and their sharp advisors (many of whom were in the government fomenting the churning laws), so take legal advantage of the laws. Those who take advantage of the loopholes are called "abuses"...which then restarts the churning cycle by calling for a new law which will have its own loopholes.

There is an even more upsetting problem which evolves from the churning and instability of benefits tax policy. Employers are becoming increasingly discouraged from providing benefits (which could mean that people would be dumped onto the troubled government plans). The churning and instability of government tax policy makes the expense and hassle of sponsoring and administering an employee benefit plan much less attractive. I understand that in many plans for small businesses, it costs as much to administer the benefits and adjust to the ever-changing government rules, as it does to pay the actual benefits for the covered workers and their families. That is shameful inefficiency imposed by the government. It is also counter-productive for the Congressional finance committees and the Department of Treasury.

If you are concerned about the amount of "revenue loss", then the Congress the Treasury, the Department of Labor, and all of the regulating agencies should strive to keep the system simple and stable...not the current chaos. Today, neither the Congress nor the Administration (nor we in the benefits industry) can tell whether a much-heralded "reform" has worked. The reform is reformed itself, sometimes even before it took effect.

I would be negligent if I did not say that this is not just a problem with tax law. THERE IS NO NATIONAL POLICY FOR EMPLOYEE BENEFITS. There is chaos and contradictory policy among all of the 70 or so governmental agencies which regulate us. It is foolish to proceed so blindly.

page 4

Your final questions relate to the effect of benefits on the employer-employee relationship in terms of choice of benefits, compensation, and even choice of jobs. Yes, employee benefits have a role and effect...but it is primarily a reflection of the social changes in this country and the increase of two-worker families. The private benefits system and employers have made a major effort to adjust to and accomodate to the new social structure. Some of the Congressional and Treasury policies seem to be telling women that only husbands should work, and that women should stay home like good little girls. I don't think that is politically desirable or feasible. Thus, Congress and the Treasury must catch up with the times. The majority of households now have two workers, and many have some form of moonlighting or extra job. It is financially wasteful for everyone to have overlapping benefits. Many workers currently live with that overlap. However, if they were suddenly taxed on the value of those overlapping or unused benefits...you would see severe personnel dislocation and unrest in this country.

In summary, the current system of employee benefits is a small reflection of...and often mandated by...the Federal Government programs. Even considering the estimated $50 billion "revenue loss" price tag, they are a cheap and efficient deal for Uncle Sam. The alternative would be a disasterous overload of government programs such as Social Security and Medicare. Unlike the government programs, the private benefit plans have been designed and maintained to be stable and adequately funded. Afterall, promised benefits...whether from Social Security or a private plan...are worthless if they go broke. The chaos caused by the government's constant churning and "reforms" of working policies causes both abuses and instability...which are then used as an excuse for even further churning and reform and so on ad infinitum. Employers are trying to meet the modern wants and needs of their employees. Under the concept of spreading risk, which is the basis of employee benefit plans, people are willing to share the costs. However, if they are suddenly getting taxation without appropriate benefit, they will rebel, just as the founding fathers of this country did over the tax on tea.

Finally, a personal look into the crystal ball with the hope that by sharing the vision, it can be avoided. I predict that in the next 5 years, the churning of laws and lack of coordinated national policy, and the increasing nibbling of taxes on benefits will severely cripple the private employee benefits. Then, sometime about 1990, the Senate Finance Committee the Committee on Ways and Means and the Department of Treasury will gather to hold hearings on the deplorable state of private benefits, and how the Congress and Administration can "save" and "help" those private plans (whose importance will suddenly have become glaringly obvious). Will it be too late? Will government have killed the golden goose? Who knows... but why find out, when we can avoid the calamity today.

Thank you.

Society of
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Benefit
Administrators

SPBA

Senator PACKWOOD. Your last point—and Bob Dole and I have talked about this—is very valid. 30 and 40 years ago, we used to have a tax reform bill every 10 or 12 years. By the time Bob and I got here, they were being done every 5 or 6 years, and now they are done every year.

Mr. HUNT. Yes, sir; and there is no time for it to sink in because even the changes take place before the bill even takes effect in some cases.

Senator PACKWOOD. Time and time and time again, business people have complained. They don't like taxes and they don't like uncertainty. Almost between the two, they would rather have the taxes than the uncertainty, but we will pass a tax bill, and before the IRS or Treasury has had a chance to issue regulations, we have changed the law a year later. So the regulations were never issued. I don't blame people for feeling frustrated.

Mr. DAVEY. I think that was a perfect example of the problem that we got into with respect to cafeteria plans. The enormous uncertainty without any guidelines, and I think that was a perfect example of a 6-year lag between when it was passed and when we even got an announcement from the IRS.

Senator DOLE. I may have a couple of questions, but I will submit them in writing.

Mr. HUNT. Let me say one thing, in defense of Senator Dole, who I know has had to be the heavy through a lot of this discussion in the past couple of months, I want to point out that this serving attack on benefits has been totally nonpartisan. There have never been the Democrats versus the Republicans. Also there has never been any villain. We are not saying that anyone is bad. However, one of my SPBA members came up and said, "you know the problem is that everybody wants to help, and the road to hell is paved with good intentions." So, I would hope you will realize that these are not slaps at you, Senator Dole.

Senator PACKWOOD. I will say something about Bob. Had he not been the strong hand that he has been, we wouldn't have raised the revenue we have raised to date. And for anybody that calls him the heavy in that, that is a cheap shot. [Laughter.]

Senator PACKWOOD. We indeed do cast away Government money rather easily, and it has to be made up some place. I don't envy the task of looking at that list that he has to try to get us to adopt. You have perhaps 80 or 90 items on it, each of which raises $50 to $500 million, and every one of those has got a built-in zealous group of opponents. He is the leader who has got to pick and choose and try to get us to adopt them, and then explain why we have had to do so.

Senator DOLE. That is why I have thought about leaving next year. [Laughter.]

Senator PACKWOOD. Fellows, thank you very much.

Mr. HUNT. Thank you, Senator.

Senator PACKWOOD. Next, we will have John Larson, manager of compensation and benefits for NERCO, Bob Sumner of Good Samaritan Hospital in Portland, and Jane Barber, the corporate benefits manager for Tektronix, which is in Beaverton, OR.

If you have no objection, we will just go in the order that your names appeared on the list. We will start with Mr. Larson.

STATEMENT OF JOHN F. LARSON, MANAGER, COMPENSATION AND BENEFITS, NERCO, INC., PORTLAND, OR

Mr. LARSON. Thank you, Mr. Chairman, and Senator Dole.

I am John Larson from NERCO, a Portland-based resource development company. We have submitted our written testimony, and I will try to abbreviate my own remarks. I think it is important for us to recognize that employers provide benefits for, I think, three reasons. One, to promote the health and welfare of the employees and their families. Two, to promote their own business productivity, and three, because they are able to do so by taking advantage of group rates and available tax incentives.

I think it is apparent that with some notable exceptions employers are not particularly creative or imaginative in the area of providing benefits and they need to be motivated oftentimes to do what will serve their employees well. We know now that the work force demographics have changed significantly since most benefits programs in place were designed and introduced, and yet those benefits have not changed appreciably.

One of the reasons that we were very interested earlier in the year in going to a kind of flexible program was because we wanted to provide some dependent care assistance for our employees whose circumstances made that a valuable benefit. We had in mind a two-pronged approach. One, to join a local organization to provide dependent care guidance and counseling services, and two, to provide a tax incentive that would make it possible for employees to buy those benefits with tax-free dollars. We didn't want to impose the benefit. We wanted to make it available on an elective basis to those who would use it, and we weren't particularly interested in providing a new benefit at company cost where utilization would be confined to a narrow class.

We deferred those efforts, but for joining that local dependent care assistance organization, when the IRS issued its press announcement, putting in a very uncertain light the effectiveness of that kind of a program. We still are very interested in moving ahead, but we are waiting for a bit more certainty.

I think we would be very much interested in providing to our entire employee population the opportunity to choose those benefits they think best suit their needs. And I think there is a fairly clear list of what those benefits would be. They would be health care. They would be life insurance. They would be dependent care assistance, long-term disability coverage, and certainly a couple of others that don't come to mind. And we are not particularly interested, I don't think, in adding legal services to that list, though it and others would be considered.

A concept that we have given some thought would have us creating—which would require some legislative changes—a sort of super 401K plan that would enable us to pay into that plan for the employees an amount equivalent to what we are now spending for benefits. Let them draw upon their own fund for qualifying benefits and let them leave in that fund those amounts that they don't draw for those purposes and pay taxes on the balance on withdrawal at retirement or termination. I think there is an interesting possibility there for people to do some very solid planning about their own futures and decide whether or not they want or need insurance, for instance. They may find as that fund grows that insurance is not important to them. Unitl the fund has grown to an adequate size, they many feel insurance is very important. I think it is important that we recognize they are probably very capable of making those decisions for themselves. And I don't think we need to put ourselves in the position of conferring benefits which may not be used useful or even wanted.

That is the end of my testimony. Thank you.

Senator PACKWOOD. Thank you. Mr. Sumner?

[Mr. Larson's prepared statement follows:]

BEFORE THE UNITED STATES SENATE,	)	
COMMITTEE ON FINANCE, SUBCOMMITTEE	)	Fringe
ON TAXATION AND DEBT MANAGEMENT,	)	Benefits
July 26, 1984	)	Summary

WITNESS: John F. Larson, Manager of Compensation & Benefits, NERCO, Inc., 111 S.W. Columbia, Suite 800, Portland, Oregon 97201. 503/796-6673.

NERCO supports flexible compensation and endorses measures to encourage its broad adoption.

Work force composition has changed since most existing benefits programs were designed and introduced.

Total compensation is the sum of pay and benefits. Underutilization of benefits conferred by the employer may result in employee perception of undercompensation when compared to a high user similarly situated.

Benefits are provided to promote employee satisfaction and improved productivity. Employer-sponsored benefits programs offer reduced costs resulting from economies of scale and existing tax incentives.

Existing benefits programs do not necessarily address employee needs because of changed work force demographics.

Flexible compensation programs allow for application of part of total compensation to the purchase of appropriate elective benefits.

Significant tax incentives would promote employer adoption and employee utilization of flexible compensation programs.

Employers are well situated to assist in the fulfillment of employee benefits needs.

Work force productivity will improve and reliance on government assistance programs will decline if employer-sponsored benefits programs are made responsive to employee needs.

To encourage employee utilization of elective benefits programs, significant tax incentives, coupled with reduced transactions costs, must continue to apply.

Employers, employees and the public will be well served by the introduction and utilization of elective benefits programs.

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BEFORE THE UNITED STATES SENATE,	)	
COMMITTEE ON FINANCE, SUBCOMMITTEE	)	Fringe
ON TAXATION AND DEBT MANAGEMENT,	)	Benefits
July 26, 1984	)	

Mr. Chairman and members of the committee:

My name is John F. Larson. I am Manager of Compensation & Benefits for NERCO, Inc., a resource development company based in Portland, Oregon. NERCO employs approximately 1,900 people in locations throughout the United States.

We support flexible compensation and endorse measures to encourage its broad adoption. We appreciate this opportunity to assist in the development of a comprehensive record on current fringe benefit topics.

In the recent past, employee benefits programs were often of uniform design to meet the needs of a stereotypic employee who was male, married and the father of dependent children. This employee's spouse was not employed, and his children were of school age. Our work force demographics have undergone considerable change since this notion prevailed. Today we would be hard pressed to describe the stereotypic employee. Clearly, the needs of employees today may not be best satisfied by existing benefits programs.

Total compensation is the sum of pay and benefits. However, the value of a standard benefits package will vary from employee to employee. A benefit conferred but never utilized has no real value to the employee; a benefit conferred and extensively utilized may have great value. The non-user may feel undercompensated, even though employer costs may be the same in both cases. Given the composition of today's work force, the potential for such disparities has increased significantly.

Apparent pay inequities resulting from varying levels of benefits utilization could be remedied by eliminating conferred benefits, providing a fair benefits allocation to each employee, and allowing the employee to enroll in an elective benefits program constrained only by the amount of the benefits allocation and the employee's willingness to pay any additional costs. Such a program would promote both cost containment for the employer and improved equities for the employee population.

Benefits are now included in total compensation as a means of promoting worker satisfaction and improved business productivity. It is also true that employee-sponsored benefits programs offer reduced costs resulting from economies of scale and existing tax incentives. Given the changed composition of the work force, benefits provided by a paternalistic employer may not be producing the desired productivity improvements. Because a fixed benefits program may not address the principal concerns of a large segment of the employee population, such paternalism may actually result in employee dissatisfaction and declining productivity. Because the granting of similar benefits to both husband and wife by different employers will often cause the value of at least one of the programs to be diminished, both husband and wife may be displeased that their employers have not allowed them to take the cash instead. And, because we would generally not seek to have others do for us what we can do better for ourselves, we may actually find it insulting that our employers feel obliged to spend a portion of our earnings on benefits not of our own choosing.

A number of employers seem to cling to the view that if benefits are made available as a matter of choice, their employees will choose unwisely or not at all. These bad choices will then somehow result in declining productivity and a tarnished reputation for the business which has shown so little concern for the welfare of its employees. Where elective benefits programs have been tried, it appears this proposition has been proven erroneous. Furthermore, in this and other contexts, it has been found that employees treated like adults often behave like adults.

Employer attention to the benefits needs of employees remains an important issue. The employer is well positioned to take advantage of reduced transactions costs, to assist employees with financial planning matters, and to offer programs which will improve worker satisfaction and business productivity. Furthermore, existing tax policy makes it possible for the employer to assist the employee in securing important benefits more economically than would be true in the open marketplace.

While employees may select wisely when presented with a choice of benefits, cost will continue to be a factor weighed heavily in their final decisions. Significant tax incentives will stimulate employee participation in employer-sponsored benefits programs. Improved business productivity and reduced reliance on taxpayer-supported assistance programs should be two key objectives in making employee utilization of employer-sponsored benefits programs an attractive proposition.

To stimulate employers to modify existing benefits programs in attending to the needs of today's work force, tax incentives in support of elective benefits programs must be encouraged. A simple, equitable and non-discriminatory approach to providing for maximum flexibility may be to allow for the establishment of a non-taxable benefits allocation equal to a fixed percentage of regular pay. All or any part of the benefits allocation could be applied to the purchase of qualifying benefits from a shopping list broad enough in scope to address the various requirements of a diversified work force. Excess costs would be paid by the employee with after-tax dollars at favorable group rates.

We believe that employees, employers and the public would be well served by efforts to stimulate the introduction and utilization of elective benefits programs. Appropriate tax incentives will be an important inducement in bringing about such change. We encourage your further consideration of this very important issue.

Thank you.

Respectfully submitted,

NERCO, Inc.

John F. Larson

John F. Larson

Manager, Compensation & Benefits

STATEMENT OF ROB SUMNER, GOOD SAMARITAN HOSPITAL & MEDICAL CENTER, PORTLAND, OR

Mr. SUMNER. Thank you, Mr. Chairman. My name is Rob Sumner, and I am here today representing Good Samaritan Hospital in Portland. We have gone, I guess, a step farther than Mr. Larson and his company in that we have implemented a cafeteria benefits plan effective on January 1 of this year.

For that reason, we have a very keen interest in the issue of taxation of fringe benefits. Our objectives in implementing the plan were many, but there were two primary objectives which we were very hopeful of attaining. One is the obvious issue of cost containment through a more efficient delivery of the employee benefits package and also through increased cost sharing for the benefits with the employees.

I am pleased to say that we have made some progress toward those objectives. The results are very favorable so far, and I have included information in my written testimony which will give you some figures on exactly how the cafeteria plan has helped us with those objectives. I wanted to bring one point out here which I think is important for us all to keep in mind on this issue. Prior to implementing the cafeteria plan, we did some very extensive surveying of our employees. The plan was made available to about 1,700 folks, and we surveyed a group of about 600 in small group discussions.

The primary purpose was to help us shape the plan to decide what benefits should be included and what should not, but we also wanted to get some general information from our employees about their feelings on the issues of employee benefits. One of the statements in the survey that they were asked to respond to was: Do you feel that your employee benefits package is (a) less important than your salary, (b) equally important, or (c) more important than your salary. And we were surprised, as I think most would be, to find out that over 70 percent of the 600 folks responding to our survey felt that their employee benefits package was as important as, if not more important to them, than their salary.

That is the kind of support that is provided by those packages. In closing, I would just ask that you, in your considerations, keep in mind—as has already been brought up—that not all employers are intending to abuse the tax incentives that are provided for employee benefits plans, that there are responsible employers who are making responsible efforts to control costs and to provide meaningful benefits to their employees, and please keep in mind our findings that the vast majority of employees covered by benefits plans place a great deal of importance on those benefits. Thank you.

Senator PACKWOOD. Thank you.

[Mr. Sumner's prepared statement follows:]

WRITTEN STATEMENT OF TESTIMONY

UNITED STATES SENATE

COMMITTEE ON FINANCE

SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

HEARING ON FRINGE BENEFITS

July 26, 1984

Good Samaritan Hospital & Medical Center is a 500 bed, teaching, research and medical facility in Portland, Oregon.

The hospital currently employs approximately 2,000 people and is the tenth largest private employer in the state.

On January 1, 1984 Good Samaritan implemented a comprehensive cafeteria benefits plan which allowed employees options in medical care coverage, life insurance, disability coverage and paid time off. A flexible spending account is also an important feature.

The Hospital has dedicated significant resources to the implementation of this program in the firm belief that the cafeteria benefits plan will have a significant impact on escalating benefits costs and will improve substantially the efficiency of our provision of non-taxable fringe benefits. This will enable us to deliver better benefits at less cost and therefore less loss of revenue to the Treasury.

The non-taxability of certain benefits under cafeteria plans is, of course, the key factor in realizing our belief as stated above.

We understand that the recent Internal Revenue Service position on

We are not opposed to, and in fact wholeheartedly support reasonable restrictions being imposed to prevent abuse. The wholesale condemnation by some parties of cafeteria and other employee benefits plans as comprising nothing more than "tax dodges" is a dangerous overreaction which needs to be focused on the abusers who are the true targets of this reasoning.

To that end, we hold up to you Good Samaritan's "FLEXPLAN" as an example of a cafeteria plan which was designed with the following objectives:

- o cost containment through more efficient delivery of benefits
- o increased employee satisfaction
- o compliance with existing tax laws and regulations

In support of these points please consider the following:

1. <u>Medical Cost Containment</u>

We, like many employers, see the cafeteria plan as the first significant change in employer-paid medical benefit arrangements that has a real chance of putting the brake on medical costs. This is because the employee, through the election process, can become directly involved in managing his or her own costs by controlling the use of medical care. If the employee's incentive is removed because the savings are not returned to the employee, the biggest potential impact on medical cost containment disappears. We sincerely believe that the existence of cafeteria plans using a funded reimbursement account will have a major effect in stabilizing medical costs and breaking the super-inflationary cycle that has been characteristic of those costs. If the funded reimbursement account is eliminated, the

2. Overall Reduction in Fringe Benfits

The cafeteria plan is a device to improve greatly the efficiency of the delivery of nontaxable fringe benefits to employees. It is our expectation that this will permit us to pay a lesser total amount for fringe benefits for all employees while delivering a better benefit for each employee. This is because the employees can tailor their benefits to their own needs. Money is not wasted furnishing benefits on a universal basis and including employees who cannot use those benefits. The result for a taxpaying employer will be less tax deduction for fringe benefits while greater benefit to employees. The funded reimbursement account is an integral part of the potential for achieving this result.

3. Enchancement of Day Care Reimbursement

It is generally conceded that reimbursement for day care is an important tax policy as evidenced by the inclusion in the Internal Revenue Code of Section 129 (covering excludable employee reimbursements) and Section 44A (covering tax credits for day care expenses). Day care expenses are extremely important to those employees who need them and are of no value to those employees who don't. Because of this, day care reimbursement is a prime candidate for a cafeteria plan. Since day care costs tend to be upredictable, flexible reimbursement rights are important in delivering this benefit. The funded reimbursement account is necessary in order for this to be feasible. As a consequence, it can be expected that there will be a significant reduction in the extent to which congressional policy on day care reimbursement will be realized if the flexible funded reimbursement acccount is prohibited.

As noted,the flexible spending account is the vehicle for reaching our objectives. In the absence of regulations governing the design of such accounts, every effort was made by our local counsel and

As a result, the hospital's flexible spending account appears to comply with the IRS proposed regulations in all aspects save one. It seemed reasonable to assume that the Treasury would prefer to have unused account balances paid to employees at the end of each year as currently taxable income.

Instead, the proposed regulations require unused amounts to be forfeited by the employee, and therefore never taxed. This no cash rule had a significant impact on Good Samaritan's flexible spending account participation.

In the best interest of the hospital employees, they were informed of the proposed regulations. As provided by the proposed regulations they were given the option of closing their account by June 1, 1984, or continuing to participate with the understanding that they may lose any unused account balance at years end. As would be expected, this caused a dramatic decrease in participation.

During the initial January 1, 1984 enrollment 552 employees designated a total of $457,000 to be deposited to the spending account.

Figures for the period January 1, 1984 to June 1, 1984 indicate the following use of these funds:

Dependent Child Care	71%	of total
Medical Care	11%	
Vision and Hearing Care	7%	
Orthodontia	8%	
Other Dental Care	3%	
	100%	

Faced with the possibility of losing any unused account balance at the end of the year, 340 employees or 62% discontinued participation.

Changes in medical coverage, life and disability insurance and in the amount of paid time off have created opportunities for employees to create packages that are better suited to their needs at less cost than the previous package. This has also created cost savings for the hospital in many cases.

For example two alternative health care plans were offered, both of which cost less than the existing coverage. One plan is a very spartan plan with a $500 per person deductible, and the other is a preferred provider type plan which requires employees to use the hospitals own facility and physicians. Over 60% of the employees opted out of their preivous high cost coverage into one of these two alternative plans.

The choices in life and disability insurance also created cost savings for the hospital. The fact that employees could have different levels of coverage required a more accurate billing and accounting system. Rather than the cost being based on a flat percentage of payroll, it is now based on actual volume of insurance. This reduced the hospital's cost for these programs by one third.

Another side effect of the program results from the new found appreciation of and satisfaction with the benefits on the part of the employees. The ongoing demand for new or more benefits has virtually stopped. This is because the employees needs can be met in one form or another under the flexible plan.

Our purpose in bringing Good Samritan's FLEXPLAN to your attention can be illustrated by the following considerations:

1. The growing sentiment that employee benefits plans, flexible or otherwise, are some sort of subtrafuge aimed at eroding the tax base of our country and lining the vaults of employers is both unfounded and dangerous for the well being of the employees covered by these plans.

2. Responsible employers recognize the need for and support well reasoned limitations and controls on nontaxable fringe benefits. Employers who do not support this need should be the target of your effort.

3. The issue of taxation of fringe benefits is one that is or should be of vital interest to every employed person in this country. The decisions you make can have a dramatic impact on the personal finances of these people. The financial impact on the employers providing these benefits should not be overlooked because of the potential inpact on the economy.

4. There are many responsible employers like Good Samritan Hospital who are making serious efforts to balance the needs of their employees and the needs of their organizations against the need to design programs that are not abusive of tax incentives.

Please use our experience and expertise gained through implementing and administering employee benefits plans to help you shape the future of tax policy on fringe benefits in a positive manner for all parties involved. That result is possible through cooperation and understanding.

Thank you,

Senator PACKWOOD. You had a particular problem with child care, as I recall, because you have people working at all hours. You just don't have the normal 8 to 4:30 and pick up your child at 5:30 problem that 80 percent of the employers have.

Mr. SUMNER. That is compounded a bit by the fact that, as is typical of a hospital, over 80 percent of our work force is female, and that does tend to increase the need for child care. Child care through a flexible spending account was a provision of our program, and we found to date that about 71 percent of the funds that are being channeled through the flexible spending account are being used for dependent child care.

Senator PACKWOOD. I would like to give an idea of how big this hospital is. It is Oregon's 10th largest employer, to put it in perspective. In Portland, it is an immense, immense hospital.

I will call upon Ms. Barber, who represents Tektronix. I would like to say to you, Ms. Barber, it is amazing that you have any employees left after I toured Sequent, Metagraphics, and Northwest Industries. You are the mother lode of all of those little electronic companies that are spinning off. Tektronix, at its zenith, employs 25,000 people. For the first time, I toured at least half a dozen smaller electronics companies around the Portland area. They employ anywhere from 200 to 500 people. There wasn't one of them that didn't have one of your engineers or vice-presidents. I won't mention which company, but I was fascinated with one employee who had just left to take on the presidency of a much smaller company for which he took a $3,000 a week salary cut. Now, he clearly wasn't going to that company with the hopes of making it up in salary in the next 3 or 4 years. It is the kind of industry that Tektronix has spawned, which is becoming a very stable employer around the Portland periphery.

Ms. Barber?

STATEMENT OF JANE BARBER, CORPORATE BENEFITS MANAGER, TEKTRONIX, INC., BEAVERTON, OR

Ms. BARBER. It is in part because of some of that entrepreneurship that has begun to stimulate spinoffs from our company, along with the cost of our benefit programs, that has caused us to just to spend a full year analyzing our benefit programs as part of our whole human resources strategy. We didn't want to add to the cost of our benefit programs any more because cash is more powerful for attracting new employees and in retaining the ones we have, but we also over the years have developed a work force that is quite diverse and our benefit program was no longer meeting the needs of most of our employees. No longer is our work force made up of the married male with a wife at home and children. Instead, we have many female employees. We have many young single employees. In analyzing our cost problem, we feel that it comes from the design and structure of our programs over the years. We made a commitment in the past—many, many years ago—that we would pay 100 percent of the cost of health insurance, life insurance, disability insurance. At the time, they were indeed fringe benefits. It didn't cost very much, and it was administratively easier to do. But, as a result, when the cost of health care began to inflate, we were simply stuck with the cost. We weren't able to control it. We weren't able to manage that expense, even though our profit at the time were such that we were looking for all opportunities to better manage costs.

Additionally, because of that structure of program, when new benefit plans came into vogue—or as our work force changed and we began to feel pressure to add new benefits—we weren't able to say, well, we will add this and let you make a choice. Instead, we simply had to add a new benefit. We had to do that in order to attract and retain the employees we wanted, or incur rather negative employee relations.

Additionally, the structure of this kind of program tends to create a rather dependent behavior on the part of employees and the citizens in our country, we believe. Employers simply have taken care of the financial needs of employees. We have not even shared information with them about the cost of the programs. They really have no idea what they cost, and they have not a whole lot of sense of their value. So, we have begun to look at what kinds of things we could do to change that, to control our cost and to begin to foster some different attitudes and behaviors on the part of people. We believe, in contrast to Treasury, where they see cafeteria benefits as an exascerbation of the cost problem—we, in fact, think that cafeteria benefits are the solution, and that they should be given a chance to run. They take a long time and significant expense to implement, but we have just—as a result of this year-long study—decided as recently as this Monday that we want to adopt one at Tektronix for the very purpose of enabling cost management. With such a program we will be able to say we will put *x* number of dollars into our benefit programs, instead of being committed to paying 100 percent of whatever the expense is. We will be able to add other benefits and let employees make choices about how to use the benefit dollars that they have available to them and better tailor the program to their needs. And at the same time, we will begin to redirect attitudes and behaviors and cause employees to understand the cost of benefits. They will be given benefit credits and be asked to spend these to their own advantage. They will begin to understand the cost of these benefits, understand their value, and begin to be treated like adults participating with us in trying to manage the costs, particularly in the case of health care where we will offer options—several options—variously priced.

They can see that, if they choose a less expensive one and take on more of the risk themselves, they then have more dollars available as cash. Most people like cash. They are not all looking for tax shelters. Or they can spend the savings on child-care assistance, or something of that sort that we are not now offering. So, we see it as having great potential to control costs and to begin to shift attitudes in our employee work force and in the country. We furthermore feel that it is conceptually in line with trying to develop more of the spirit of entrepreneurship within our company by saying you make some choices, you are responsible, and you participate in helping the company be a success.

Thank you.

[Ms. Barber's prepared statement follows:]

FRINGE BENEFITS TESTIMONY
BY
JANE BARBER
ON BEHALF OF
TEKTRONIX, INC.
BEAVERTON, OREGON

BEFORE THE
UNITED STATES SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
WASHINGTON, D.C.
JULY 26, 1984

Tektronix Statement
Fringe Benefits

SUMMARY

Federal tax policy in conjunction with employer self-interest in offering benefits as part of a human resources strategy, have fostered the development of privately-managed social programs which have done this country, its communities and its citizens a great deal of good over the years. Before further changes are made to the tax codes which have stimulated the formation and continuation of benefit plans, Tektronix urges Congress to step back and consider what it wants social policy to be during coming years.

We believe the policy should be one that fosters self-responsibility and provides options which will make it attractive for people, in conjunction with the employers for which they work, to make wise personal decisions and to plan and save for their own financial futures. Examples of how these goals can be achieved are 401(k) cash or deferred plans and Section 125 cafeteria plans.

"Cafeteria" benefit programs have, in our opinion, the potential to provide long term solutions to some problems created by the more traditional design of benefit plans. We believe they will enable us to better manage our benefit costs, foster a sense of self-responsibility on the part of employees and better meet the needs of a diverse work force. In particular, we look forward to a cafeteria benefits plan helping us with our strategy to restrain increases in the cost of health care.

Introduction

Mr. Chairman, my name is Jane Barber. I am the Benefits Manager for Tektronix, Inc., headquartered in Beaverton, Oregon. In that role, I am responsible for designing and administering the company's benefit program.

Tektronix is Oregon's largest private employer with more than 15,000 employees. We also employ 2,000 people at our Clark County facility near Vancouver, Washington and another 1,900 people at sales and service offices in 29 states.

Tektronix is an electronics company that manufactures sophisticated test and measurement equipment, television products, computer graphics terminals and peripherals, and computer-aided design equipment. Our total sales in the fiscal year just completed were $1.3 billion. To be successful in our chosen market and to generate the profits from which tax revenue can be derived, we must attract, retain, and motivate high-performing employees. They are our most important resource. They create the product ideas, they design the products, they manufacture the products, and they represent the product in the marketplace.

Benefit Programs As Part Of Human Resources Strategy

Tektronix believes benefit programs have an important role to play in helping us to have high-performing employees. Along with cash compensation, they form a part of the package which attracts employees to our company and through which we reward performance. They help our employees be more productive by relieving them from worry about what the financial consequences for themselves and their families would be if they were to incur large medical or dental bills, or the loss of income through disability or death. Company provided education programs assist employees to increase their potential and to adapt to changing job requirements, so they may continue to be an effective part of a high-performing team. We have a profit sharing program and an employee stock purchase program, which provide productivity incentives and allow employees to share collectively in the success of the company.

Social And Economic Implications Of Benefit Programs

The tax policy of the United States, as well as employer self-interest in offering benefits as part of a human resource strategy, have fostered the development of privately managed social programs which have done this country, its communities, and its citizens a great deal of good over the years.

Through employer-offered health insurance programs, families have been kept from becoming destitute as a result of medical bills for serious illness or injury. And, through the affordability of good medical care, people have been restored to good health and productive lives. Through disability income insurance programs, combined with health insurance programs, employees who became so disabled they could no longer work have been able to maintain a reasonable standard of living without turning to their communities for charity or to government for more assistance. Group life insurance programs have replaced income for families of deceased wage earners for a transitional period until they were able to restructure their lives and find other means to provide for the family.

There is, of course, a cost for these programs. In the fiscal year just ended, Tektronix spent $26 million of its sales on health, life and disability income programs. Because these programs are tax deductible for the company and tax-exempt for employees, the government shared in this cost. However, I believe this was a cost-effective expenditure for the government, assuming the social needs should have been met somehow.

To provide an example which I know is over-simplified but which illustrates the dynamics, last year my company spent $26 million on benefit programs, and the government lost revenue of approximately $12 million. If we assume that the government, instead of Tektronix, had provided the same $26 million to meet the security needs of our employees, then it could be concluded that Tek would have lost a tax deduction of $26 million which would have yielded the government increased revenue of $12 million. The net effect for the government would have been a loss of $14 million. This would seem to be the wrong direction for a country seeking to reduce its deficit. What would have happened if the company's contribution to these programs had been taxable income to employees? In the short term, the government's share of the cost would have been reduced to something less. However, there are problems with this approach. Even now, we have employees who receive more than $50,000 in life insurance calling us and saying, "Look, if I've got to pay tax on that amount, I'd rather have it in cash." If all benefit contributions created taxable income to employees, I think it's fairly predictable that more and more employees would begin to pressure their employers to give them cash instead of benefits. That might be fine from the point of view of raising revenues, but it would encourage people to take risks with their security. When they then fell ill, became disabled or died, society would have to develop the means to take care of them and their families. In short, taxation of these benefits might create short term revenue solutions, but it most certainly would create long term social problems. Another factor which must be considered is that the money Tektronix spent on those programs last year did not just go down a drain never to be seen again. In the case of the health, life and disability programs, it was paid out in benefits to persons who purchased goods and services, which in turn, helped maintain or broaden the tax base from which the government derived revenue. To the degree it contributed to the success of businesses or institutions who buy Tek products, some part of it will come back to Tek in the future.

Despite the good these programs and the other social programs of the United States have done over the years for individuals, employers, communities and the country, I also believe they have created some problems through their structure and design. They have shielded people from the economic realities of life, much in the same way as a parent does who pays all the bills a teenager runs up. As a result, they have stimulated some undesirable results: uncontrolled costs, particularly in the case of health insurance; an expectation that government or employers have an obligation to keep providing more benefits; and a minimal understanding on the part of individuals that they have a responsibility to participate in providing for their own security. Just as the current design of programs, with their attendant messages, have created certain behavior and attitudes, I believe redesigned programs and appropriate tax incentives can do their part in creating improved results.

The legislation that enabled Individual Retirement Accounts and 401(k) cash or deferred plans are excellent examples of how tax policy can stimulate positive behaviors and desirable social goals. More people are now saving for their retirements and feeling proud of themselves for doing so. These programs are fostering independence and a sense of self-responsibility. The money which is being saved on a tax deferred basis is being plowed back into the economy through investment and is broadening the tax base for national, state and local programs. They do not foster the notion that people have a "right" to total economic security from the government or employers, which creates dependent behavior and an appetite which can never be appeased. Instead, these programs send a message that the government believes it's good for people to help themselves.

"Cafeteria" Benefit Plans And Cost Management

Another piece of legislation which I believe to be capable of providing some solutions to the problems created by the traditionally designed programs is that which enabled "cafeteria" benefit plans. My company has just completed a year-long study of our benefit program for the purpose of identifying changes which would enable better cost management, better meet the needs of our now diverse workforce, and better foster a sense of self-responsibility on the part of employees. And, we wanted to do these things while enhancing employee relations. It's our conclusion that a cafeteria benefits plan will allow us to meet our objectives, while still assuring that the positive social purposes of current programs will be continued.

The essence of the program we plan to design and implement is to create benefit "credits" by shrinking the portion of the program which employees automatically receive down to a minimum core. These credits can then be used to purchase the same benefits they have now, a different combination of benefits which may be more appropriate to their needs than the company-designed program has been, or they may trade them for cash. Conversely, they may spend some of their cash compensation to buy additional benefits (instead of asking the company to provide additional benefits). The core would assure that all employees still had some level of financial security, and that social purposes would be met. Also, the tax exempt nature of the benefit options, as opposed to the cash option, will provide employees with an incentive to continue reasonable levels of insurance protection.

This approach to benefits helps employees better understand there is a cost to benefits, and it sends a message that employees have a personal responsibility for identifying and planning for their own financial security. It also enhances cost management in several ways. The company will be able to set a limit on how much it will spend on benefit programs each year, instead of automatically absorbing whatever expense is generated by our current commitment to pay 100% of the cost of various plans. It will allow us to help meet new benefit needs, such as child care assistance, without necessarily adding to the total cost of our program. And, employees will have financial incentives to become better consumers of benefits, especially health care benefits. They will have a choice of health plans, with varying amounts of "first dollar" cost for incurred health care expenses, as well as varying costs for buying the insurance. If they choose a less expensive option than the plan we now offer, they may buy other benefits or receive cash. We believe this power of decision and the opportunity to receive cash will begin to cause people to be more cost-conscious and self-responsible consumers of health care services. We expect this, over time, will reduce the current demand on the health care system for all of the most expensive kinds of services that are available. We even hope it may begin to motivate people to take better care of themselves, since people staying well is the ultimate health care cost management strategy. As a companion to offering financial incentives to use the health care system more wisely, we will be providing employees with a great deal more information than we have in the past to help them know how to do so.

While on the subject of health care cost management, I'd like to say a few words about the strategy of putting a cap on the amount of tax-exempt contribution a company can provide for an employee's health insurance. It is my opnion this would do little or nothing to control the cost of health insurance. It would simply add to an employee's taxes, without doing anything to solve the underlying problems. It would be similar to a company deciding to solve its health cost problems by simply shifting more expense to employees. It would aggravate the employees without providing a way for them to help find solutions or to lower their expenses. It might increase revenues slightly, but then the government would be in the strange position of hoping health care costs didn't go down, because if they did, revenues would be reduced.

Conclusion

Congress must draw its own conclusions about the social value of benefit plans provided by the employers of the U.S. and how to structure tax policy. It is my strong recommendation, however, that Congress decide what it wants the social policy of the United States to be before more changes are made to the laws which have stimulated the formation and continuation of the plans serving social needs.

My personal belief is that the policy should be one that fosters self responsibility and provides options which will make it attractive for people, in conjunction with the employers for which they work, to make wise personal decisions and to plan and save for their own financial futures. Through this partnership of government, employers and employees, a vast segment of our population will have financial security when serious illness strikes, when wage earners become disabled or die, and when the day for retirement arrives. Through employer-sponsored plans, the government is relieved of the need to provide for these same life events which occur in every family at some time. By fostering a notion of self-responsibility, I believe people will feel more involved in their own futures, which in turn will play its role in helping this country of ours to be more productive and competitive in the world market place.

By personal experience in trying to redesign my company's benefit program to meet current and future needs, I know that the only way to sensibly decide what changes ought to be made is to step back and ask, "What are our objectives?", "How do we want people to behave?", "What are the alternative objectives?" Once you've answered those questions, it becomes clearer how to structure the programs and where to place the incentives and disincentives.

Tektronix thanks you for this opportunity to testify.

Senator PACKWOOD. Who carries your health insurance?

Ms. BARBER. We are self-insured. We have several HMO's as options around the country, but on our Tek health plan, it is a self-insured plan. We fund it through a 501-C-9 trust. Again, we see that not as a tax shelter, but as a way to control costs.

Senator PACKWOOD. Now, under your self-insured program the employee can go to any doctor or any hospital? Or do you have certain ones that they go to?

Ms. BARBER. No; they can go to any doctor or any hospital. We do feel that the current structure of the plan in a sense creates demands—unnecessary demands—which is why we want to begin to offer a differently designed plan and several options, and at the same time begin to provide an education and communication program so employees know how to use their plan—how to save themselves money. If they choose a plan where they take on more risk, then we feel the obligation to tell them, for example, that outpatient surgery could be used in this case and it would cost you less. Right now, if we tell them that, they have no incentive to choose less expensive care because it is not going to cost them anything.

Thank you. I have no other questions. Bob.

Senator DOLE. I have no questions.

Senator PACKWOOD. Thank you very much.

Senator DOLE. They are doing a good job, as are you, Bob.

Senator PACKWOOD. Now, we will take a panel starting with Bob McGlotten, representing the AFL-CIO, Dick Warden, representing the United Automobile Workers, Mike Tiner, representing the United Food & Commercial Workers, Loretta Johnson, representing the American Federation of Teachers, and John DeConcini, the chairman of the board of trustees and international president of the Bakery, Confectionery & Tobacco Workers International Union.

Senator DOLE. Senator Packwood will be right back, but I think we can go ahead and start.

STATEMENT OF ROBERT McGLOTTEN, ASSOCIATE DIRECTOR, DEPARTMENT OF LEGISLATION, AFL-CIO, WASHINGTON, DC

Mr. MCGLOTTEN. Thank you very much, Senator Dole. My name is Robert McGlotten. I am the associate director of legislation for the AFL-CIO. Accompanying me is Steve Koplan, who is one of our legislative representatives. Senator, I will summarize my statement. I request that the statement be included in the record.

Senator DOLE. All the statements will be made a part of the record.

Mr. MCGLOTTEN. Thank you. The AFL-CIO appreciates the opportunity to state our views on tax-policy issues surrounding fringe benefits. Mr. Chairman, we appreciate your consistent and longstanding support for fair tax treatment of American workers. We are pleased that this inquiry is being conducted away from the heat of a legislative battle, and we look forward to recommendations which will treat the issue of fringe benefits fairly and not be used as a method to shift more of the tax and deficit-reduction burden onto workers and away from corporations and the wealthy.

This year's tax laws included useful measures that will raise revenue and eliminate some abuses, but it leaves in place a vast array of tax benefits for rich individuals and for the corporate sector. In addition, the 1984 law included many provisions by which the Congress in its frantic search for deficit reduction revenue callously jeopardized or wiped out hard-fought gains of workers. For example, American workers will suffer as a result of provisions regarding voluntary employees' beneficial associations [VEBA], supplemental unemployment compensation benefit trust subs, and group legal service organizations. Although professional corporations used mainly by doctors and lawyers have abused the tax treatment of contributions to these plans, it was conceded that there hasn't been any evidence of abuses in plans collectively bargained by the unions. Despite the absence of any demonstrated abuses in collectively bargained plans, the 1984 tax package contains limits on the ability of employers to deduct sums paid to fund such plans. This provision would jeopardize the ability of programs to provide such important benefits as health and welfare, long- and short-term disability, medical subs, severance pay, et cetera.

American workers again will suffer as a result of termination of the statutory exclusion from income of benefits provided employees under an educational assistance program. This statutory fringe benefit expired on December 31, 1983. The 1984 tax package rejected efforts to extend the exclusion until January 1, 1986. These programs provided significant opportunities to women, minorities, and other workers to upgrade and maintain their skills as part of training and retraining provided by employers, often as a result of collective bargaining. An extension of this statutory fringe benefit would not have resulted in any significant revenue loss to the Treasury. Again, Mr. Chairman, American workers will suffer as a result of adoption of the dollar limits on benefits under qualified pension plans for airline pilots. In this context, the taxation of fringe benefits should not be the focal point of tax reform. In December 1979, the AFL-CIO convention set forth general standards with respect to the taxation of fringe benefits. That statement is included in my statement, and I would like it included in the record.

With regard to group legal service plans, we continue to urge that the Congress adopt S. 2080, a bill to make permanent section 120 of the Internal Revenue Code, and thus continue to encourage qualified group legal service plans. We believe that concerned tax treatment of qualified group legal service plans has helped in encouraging the use and protection of such plans at minimal cost. There is no evidence that such plans have been abused, exploited as tax shelters, or led to inequities, or discriminatory practices. The Senate Finance Committee has considered legislation to pace annual limits per family and per individual on the amount of tax-free contributions employers would make to workers health insurance plans. Any amounts over these limits would be taxable as income to employees. The presumption is that this will make workers more cost conscious and control rising health costs, and at the same time raise revenue. Placing a limit on tax-free employer contributions to health insurance or making any amount over that taxable as income to employers will provide a strong incentive for unions to seek to have employer contributions which exceed the Federal tax to other tax-free or tax-deferred benefits. This mitigates the claim that the adoption of such a proposal would lead to a substantial increase in the Federal tax revenue. Eliminating altogether the tax-free status of health care contributions would force millions of low- and middle-income workers to give up their protection against the health-care costs of getting sick.

The rationale is based on the fundamental law of supply and demand. It is the so-called market solution to our health-care crisis. Unfortunately, the health-care market does not function like other sectors of the economy. The principle of supply and demand does not adequately predict behavior in the health-care marketplace. In other words——

Senator PACKWOOD. No matter how fast you read, you will not be able to finish this in time. [Laughter.]

Mr. MCGLOTTEN. Senator, fine. Thank you. I will conclude my statement. [Laughter.]

Senator DOLE. The last part is better than the first part.

Mr. MCGLOTTEN. I was trying, Senator Packwood.

Senator PACKWOOD. Dick.

[Mr. McGlotten's prepared statement follows:]

84-52

Testimony of Robert McGlotten, Associate Director, Department of Legislation
American Federation of Labor and Congress of Industrial Organizations
Before the Subcommittee on Taxation and Debt Management
of the Senate Finance Committee
on the Taxation of Fringe Benefits

July 27, 1984

The AFL-CIO appreciates the opportunity to state our views on tax policy issues surrounding fringe benefits. Mr. Chairman, we appreciate your consistant and long-standing support for fair tax treatment of American workers. We are pleased that this inquiry is being conducted away from the heat of a legislative battle and we look forward to recommendations which will treat the issue of fringe benefits fairly and not be used as a method to shift more of the tax and deficit reduction burden onto workers and away from corporations and the wealthy.

The Economic Recovery Tax Act of 1981, with its massive, unfair, and unnecesary tax giveaways, has left the federal government with huge and persistent deficits. These deficits and the resulting borrowing needs of the Treasury are pushing up interest rates, the value of the dollar and the trade deficit.

In addition to its damaging implications for the health of the economy, the 1981 tax law introduced gross inequities into the federal tax structure. The so-called across the board cuts in personal income tax rates gave vast and unfair reductions to higher income earners. On the business side, the accelerated cost recovery system and other new tax benefits virtually eliminated the corporate income tax.

The 1982 tax law -- the Tax Equity and Fiscal Responsibility Act -- did recover some revenue as well as address several of the inequities introduced by the 1981 tax law. Nonetheless, the huge revenue losses caused by the 1981 law continue and most all of the major loopholes that benefit business and the wealthy remain intact, while several regressive excise taxes were enacted.

This year's tax law includes useful measures that will raise revenue and eliminate some abuses. But it leaves in place a vast array of tax benefits for rich individuals and for the corporate sector. In addition, the 1984 law includes many provisions by which the Congress, in its frantic search for deficit reduction revenue, callously jeopardized or wiped out hard-fought gains of workers. For example:

* American workers will suffer as a result of the provisions regarding voluntary employees' beneficiary associations (VEBAs), supplemental unemployment compensation benefit trusts (SUBs), and group legal services organizations. Although professional corporations -- used mainly by doctors and lawyers -- have abused the tax treatment of contributions to these plans, it was conceded that there has not been any evidence of abuses in plans collectively bargained by unions. Despite the absence of any demonstrated abuses in collectively bargained plans, the 1984 tax package contains limits on the ability of employers to deduct sums paid to fund such plans. This provision could jeopardize the stability of programs that provide such important benefits as health and welfare, long and short-term disability, medical, SUBs, severance pay, etc.

* American workers will suffer as a result of termination of the statutory exclusion from income of benefits provided employees under an educational assistance program. This statutory fringe benefit expired on December 31, 1983. The 1984 tax package rejected efforts to extend the exclusion until January 1, 1986. These programs provided significant opportunities to women, minorities and other workers to upgrade and maintain their skills as part of training and re-training provided by employers, often as a result of collective bargaining. An extension of this statutory fringe benefit would not have resulted in any significant revenue loss to the Treasury.

* American workers will suffer as a result of elimination of retroactive application of amendments made by the Multiemployer Pension Plan Amendments Act of 1980. The MPPAA was enacted on September 26, 1980. Generally, it imposes liability on an employer who withdraws from a multiemployer defined benefit pension plan. The withdrawal liability

provisions of the MPPAA basically apply retroactively to withdrawals after April 28, 1980. The conference agreement includes a Senate provision that wipes out any employer liability prior to September 26, 1980. During this five month period many employers moved to withdraw from multiemployer programs in the hope of escaping their responsibilities to their employees. Thus the purpose of the April 28 date. By rewarding employers who withdrew during this period the pension plans and the responsible employers who did not take such action will face additional funding burdens. If these added costs cannot be met, benefits may be reduced and liability increased for the Pension Benefit Guaranty Corporation.

* American workers will suffer as a result of adoption of the dollar limits on benefits under qualified pension plans for airline pilots. The Tax Equity and Fiscal Responsibility Act of 1982 required that if benefits begin before age 62, the dollar limit on benefits under a qualified pension plan be actuarially reduced to reflect the value of early payment. However, federal regulations require that commercial airline pilots retire at age 60. The 1984 tax package dropped a provision that would have limited reduction for early retirement only to those commercial airline pilots whose benefits begin before age 60.

In this context, the taxation of fringe benefits should not be the focal point of tax reform.

While not specifically fringe benefits, there are two additional areas in the 1984 tax legislation which are also harmful to American workers:

* American workers will suffer as a result of excise taxes on distilled spirits and continuation of the telephone excise tax. These excise tax increases add up to about $4.5 billion by the end of FY '87 that unfairly fall heaviest on workers. Excise taxes are the unfairest taxes, falling heaviest on those least able to pay. The 1984 tax package could easily have reached the necessary budgetary targets through other means.

And, though less directly, American workers will also suffer as a result of the revenue losses in the bill due to the "Foreign Sales Corporation" (FSC) provisions and forgiveness of the tax on income that firms, through their "Domestic International Sales Corporations"

(DISCs), have been deferring for years; the one year extension of the so-called Targeted Jobs Tax Credit which would otherwise have expired on December 31, 1984; the phase out of the 30 percent withholding tax on interest paid to foreign portfolio investors; and the decrease in the holding period for long-term capital gains from one year to six months.

In December 1979, the AFL-CIO Convention set forth general standards with respect to the taxation of fringe benefits. The Convention urged that the Congress should establish guidelines for the taxation of fringe benefits. These are:

1. Sensible "de minimis" rules that assure that employers and employees need not take into account small benefit values which would cause unreasonable record keeping and administrative burdens.

2. Benefits that are necessary to the performance of workers' duties or are provided for the convenience of the employer, such as the furnishing of uniforms, should not be taxed.

3. Limited benefits, generally and historically available to employees, such as discounts for retail store employees should not be taxed.

4. Present statutes, which expressly grant tax exemptions under limited circumstances for benefits, such as qualified pension plans, group life insurance, health benefits, group legal services, employee death benefits, educational assistance programs, moving expenses, should be continued.

The Convention also stated that "... any measures to change current practice be considered within the context of an overall program of tax justice -- a program which fully addresses the tax avoidance opportunities of the wealthy and the corporations and does not add to the already unfair share of the tax burden borne by workers."

With regard to group legal services plans, we continue to urge that the Congress adopt S. 2080, a bill to make permanent Section 120 of the Internal Revenue Code and thus continue to encourage qualified group legal service plans. We believe that current tax treatment of qualified group legal service plans has helped in encouraging the use and protections of such plans at minimal cost. There is no evidence that such plans have been abused, exploited as tax shelters, or led to inequities or discriminatory practices.

In addition, in its search for revenue, Congress may attempt to deal with problems that should not and cannot be effectively dealt with through the tax code. Let me provide a good example.

The Senate Finance Committee has considered legislation to place annual limits per family and per individual on the amount of tax-free contributions employers could make to worker health insurance plans. Any amounts over these limits would be taxable as income to employees. The presumption is that this will make workers more cost conscious and control rising health costs and, at the same time, raise revenue.

Placing a limit on tax-free employer contributions to health insurance and making any amount over that taxable as income to employees would provide a strong incentive for unions to seek to have employer contributions which exceed the federal cap shifted to other tax-free or tax-deferred benefits. This mitigates the claim that the adoption of such a proposal would lead to a substantial increase in federal tax revenues. Eliminating altogether the tax-free status of employer health care contributions would force millions of low and middle income families to give up their protection against the high cost of getting sick.

Those who advocate eliminating tax preferences for employer health insurance contributions or placing a cap on tax-free employer contributions grossly overstate the potential for such proposals to reduce health care inflation. The underlying premise of their argument is that the passage of an employee health tax would give consumers strong economic incentives to reduce their coverage which would, in turn, force them to reduce their demand for health care and force providers to reduce the price they charge for services.

This rationale is based on the fundamental laws of supply and demand. It is a so-called "market solution" to our health care crisis. Unfortunately, the health care market does not function like ther sectors of our economy. The principles of supply and demand do not adequately predict behavior in the health care market place. For example, a recent article in the Journal of Human Resources used data from the Department of Health and Human

Services (DHHS) to conclude that health care expenditures which were initiated by physicians represented 89 percent of total health care expenditures.

In other words, unlike other markets where consumers make their own purchasing decisions, in health care physicians function as purchasing agents for patients. Physicians decide when patients need to go into the hospital, how long they stay, and what tests and medications they receive while they are there. Organized labor believes, therefore, it would be extremely unfair for Congress to pass a health tax which would penalize patients for situations over which they have little control.

For those who believe imposing a health tax on employees will reduce health care costs, we invite them to discuss this issue with labor negotiators who tell us that, if tax preferences for health care contributions are scaled back, what will be dropped from benefit plans is coverage for preventive care, outpatient diagnostic services, dental, eyeglasses and other benefits which save money. What would be left intact is coverage for hospital and surgical benefits which have been the major source of our health inflation problems and over which patients have very little control.

The AFL-CIO would like to make it clear that, contrary to what advocates of the employee health tax seem to believe, health care is not free to workers. Far from it. Workers make tough economic decisions and pass up other benefits, including wages, at the bargaining table to preserve the health care coverage they do have. A number of unions around the country have reluctantly accepted wage concessions just to preserve health care coverage. All of our members are extremely sensitive to the rising cost of health care services and in collective bargaining have had to make great sacrifices. This would not have happened if Congress had passed a comprehensive cost containment program to reduce the rate of growth in total health care costs along the lines of the Kennedy-Gephardt bill.

There are those who claim that health insurance benefits are unnecessary subsidies for higher wage workers. We do not accept that allegation but the fact is that it is not just higher wage workers who would be affected. The AFL-CIO urges Congress to consider the effect of limiting the tax preference for health care contributions on middle and low income families, older workers and those with chronic conditions. There is evidence which suggests that the health tax could turn back decades of progress we have made in insuring workers against the high cost of getting sick.

Employers contribute the same amount for health care coverage per employee, regardless of income. As a result, health benefits as a percent of income are more valuable to families at lower wage levels. Limiting tax-free contributions would, therefore, place a disproportionate burden on middle and lower income workers who would find it much more difficult to maintain their level of benefits. Individuals with higher incomes would probably purchase supplemental health insurance policies to assure that their present coverage is not interrupted.

Contrary to the commonly held belief that only members of the Auto Workers and Steelworkers unions would be affected by the employee health tax, a large number of other union members would suffer including the Machinists, Letter Carriers, Operating Engineers and the American Federation of State, County and Municipal Employees. Members in some of these unions have comprehensive health insurance plans; others have less comprehensive coverage. However, all of these plans provide coverage to workers and their families at a cost that exceeds any of the federal limits which have been proposed thus far.

Another issue that cannot be ignored is the situation where employees do not have policies which could be considered highly comprehensive, but which nevertheless would exceed the proposed limits. Their premium rates reflect high health care costs in their areas, the age and health status of their group, or both. For example, health benefit contributions for employees covered by International Union of Electrical Workers' contracts range from 80 cents per hour in Oklahoma and Texas to $1.16 per hour in California and $1.41 per hour in New Jersey.

In many ways the employee health tax is á straw man for those who have a fundamental aversion to the idea of the federal government regulating what are now staggering rates of increase in hospital and physicians' services. However, these same individuals are willing to impose a limit on employer funded health insurance benefits because they believe that somehow forcing employees to pay taxes on benefits would dampen health care inflation. Ironically, the health tax proposal would impede the development of cost effective HMOs, which offer more comprehensive coverage but often at higher than average premiums.

We believe any version of the employee health tax proposal would significantly erode the progress workers over decades have made in collective bargaining. This Subcommittee must ask itself whether health care is the right place to look for ways to reduce deficits. It must not confuse cost containment with revenue raising.

In conclusion, Congress has too often enacted tax legislation that disproportionately burdens low and middle income workers and too often has considered legislation from the narrow focus of raising revenue unaware that such legislation will have a major and adverse impact on collectively bargained fringe benefits. Congress should not consider changing the current practice with respect to fringe benefits except within the context of an overall program of tax justice. Nor should it attempt to deal with problems that can't be effectively dealt with through the tax code such as trying to control health costs by taxing workers' health insurance.

STATEMENT OF RICHARD WARDEN, LEGISLATIVE DIRECTOR, THE INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA [UAW], WASHINGTON, DC

Mr. WARDEN. Thank you, Mr. Chairman. I don't know whether I can read faster than Bob, but I will try. Mr. Chairman, my name is Dick Warden, and I am the legislative director of the UAW. Accompanying me today is Alan Reuther, UAW assistant general counsel. We will appreciate our full statement being filed for the purpose of the hearing record.

At the outset, Mr. Chairman, we wish to commend you for your leadership in the area of employee benefits. The UAW represents 1.5 million active and retired members and their families. The collective-bargaining agreements negotiated by the UAW provide our members with a variety of employee benefits including pensions, income protection during layoffs, health care, life insurance, legal assistance, and education and training. The UAW strongly opposes proposals to eliminate or restrict the favorable tax treatment accorded such benefits.

We believe such proposals would impose unjustified costs on the network of protection for our members, their families, and millions of other workers who might not be able to afford the same protection on their own. Our position does not represent a blanket endorsement of tax-favored treatment for all fringe benefits. We believe the tax treatment of employee benefits should be based upon an evaluation of the merits of the particular benefit involved, including its actual or expected utility to various income and demographic groups.

We draw a sharp distinction between those employee benefits which protect wage earners from the vissisitudes of illness, old age, or layoff through mechanisms they could not set up by themselves and those which are primarily used as a device to shelter earnings for small groups of upper-income individuals. Our support for granting favorable tax treatment for certain employee benefits does not mean that we have abandoned our long-standing support for meeting social needs with Federal programs in favor of a private sector approach.

On the contrary, we still advocate comprehensive Federal programs as the best means for making retirement income, health care, training, and other benefits available on an equitable basis to the largest number of persons. But in the absence of Federal action, the UAW recognizes that employer-provided fringe benefits are the only way to ensure that large groups of workers have access to necessary protection. Employee benefits have been targeted as a source of revenue, partly because of the concern about huge Federal deficits, which are projected for the indefinite future. We agree that the deficits must be reduced, but we think that taxing employee benefits is not the way to do it. The deficits in our judgment stem from the enormous and unnecessary increases in defense expenditures. This administration, coupled with the huge and wasteful tax cuts that were enacted in 1981. The deficits should therefore be attacked by scaling down, we believe, the projected costs of military spending and by repealing or reducing some of the costly tax provisions that were passed in 1981. Many employee benefits, including some negotiated by the UAW, are received in cash and subject to a taxation along with earnings. Vacations, holidays, disability insurance payments fall into the cash category. In our view, there is an important distinction to be made between these benefits and those which are rendered only as services and cannot be converted to cash.

Our prepared statement discusses in detail our views on specific employee benefits including health care, retirement plans, educational assistance, and group legal services, and others. We continue to oppose efforts of the administration to impose a tax cap on health care benefits. We urge the Congress to reinstate the tax-exempt status of educational assistance benefits and to make permanent tax-exempt status of prepaid legal services benefits, such as you have proposed, Mr. Chairman. Finally, Mr. Chairman, I would like to once again thank this committee for the opportunity to testify. Our prepared statement focuses on a number of employee benefits, pointing out that they warrant favorable tax treatment because of their merits and the role that they play in the lives of many people. Thank you again, Mr. Chairman.

[Mr. Warden's prepared statement follows:]

July 26, 1984

Statement of

Dick Warden, Legislative Director, UAW

On the Subject of

Taxation of Fringe Benefits

before the

Subcommittee on Taxation and Debt Management

of the

Committee on Finance
United States Senate

On behalf of:

International Union, United Automobile,
Aerospace & Agricultural Implement
Workers of America, (UAW)

Mr. Chairman, my name is Dick Warden. I am the Legislative Director of the UAW. I appreciate the opportunity to testify before this Committee on behalf of the UAW concerning the tax treatment of employee benefits. Accompanying me is Alan Reuther, UAW Assistant General Counsel.

At the outset, the UAW would like to commend the leadership displayed by you, Mr. Chairman, in the area of employee benefits. On issue after issue – taxation of health care benefits, continuation of the tax-exempt status for educational assistance and pre-paid legal service benefits, the imposition of limits on the funding of VEBAs and SUB plans — you have consistently advocated policies to encourage the growth and development of fringe benefits that provide employees with important protections. The UAW appreciates your efforts, and we look forward to working with you in the future on these issues.

The UAW represents 1.5 million active and retired members and their families. The collective bargaining agreements negotiated by the UAW provide our members with a variety of employee benefits, including pensions, income protection during layoffs, health care, life insurance, legal assistance, and education and training. The UAW strenuously opposes proposals which would eliminate or restrict the favorable tax treatment accorded these benefits. We believe such proposals would impose unjustified costs on the network of protection for our members, their families, and millions of other workers who might not be able to avail themselves of the same protection on their own. Moreover, taxation of these employee benefits would unfairly increase the relatively excessive tax burden shouldered by moderate income households.

I want to emphasize that our position does not represent a blanket endorsement of tax-favored treatment for all fringe benefits. We believe that the tax treatment of employee benefits should be based on an evaluation of the merits of the particular benefit involved, including its actual or expected utility to various income and demographic groups. Using this yardstick, we have strongly urged Congress to retain the tax-free status of health insurance benefits, pre-paid legal benefits, and educational assistance benefits, which have recently come under challenge. On the other hand, we did not oppose the employee benefit changes in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) or the taxation of group life insurance benefits above $50,000, and strongly support measures which make favorable tax treatment contingent on non-discrimination and other requirements. We also have advocated repeal or reduction of the tax expenditures for 401(k) plans and other tax avoidance devices.

In other words, we draw a sharp distinction between those employee benefits which protect wage-earners from the vicissitudes of illness, old age, or layoffs through mechanisms they could not set up by themselves, and those which are primarily used as a device to shelter earnings for small groups of upper income individuals.

The UAW's support for granting favorable tax treatment to certain employee benefits does not mean that we have abandoned our long-standing support for meeting social needs with federal programs in favor of a private sector approach. On the contrary, we still believe comprehensive federal programs are the best means of making retirement income, health care, training and other benefits available on an equitable basis to the largest number of persons. Specifically, we continue to support enactment of a national health insurance plan and an effective federal job training program. Government programs are the best way to insure that displaced workers, minorities, women and the poor share fairly in the progress made by the rest of society.

But in the absence of federal action, the UAW and other unions have understood that employer-provided fringe benefits are the only way to insure that large groups of workers have access to necessary protection. Government backing through tax exemptions and deferrals is therefore justifiable for workers to preserve the protection that they now enjoy.

Employee benefits have been targetted as a source of revenue partly because of concern about the huge federal deficits which are projected for the indefinite future. Although we agree that the deficits must be reduced, taxing employee benefits is not the way to do it. The deficits stem from the enormous and unnecessary increases in defense expenditures of the Reagan Administration coupled with the huge and wasteful tax cuts that were enacted in the Economic Recovery Tax Act of 1981 (ERTA). The deficits should therefore be attacked by scaling down the projected course of military spending and by repealing or reducing some of the costly tax provisions that were enacted in 1981 and more recently in 1984 — especially those which eroded the corporate tax base and are further lining the pockets of rich individuals.

Saddling the middle class with taxes on employee benefits to raise additional federal revenues would simply compound the inequities created by ERTA and make the tax code even less progressive than it already is. We believe this would be perceived as fundamentally unfair by the public, and thus only serve to fuel the "tax revolt" mentality by undermining support for the tax system and for useful social programs.

Many employee benefits, including some negotiated by the UAW, are received in cash and subject to taxation along with earnings. Vacation, holiday, and disability insurance payments fall in the cash category. In our view, there is an important distinction between these benefits and those which are only rendered as services and cannot be converted to cash under any circumstances. The imposition of income or FICA taxes on non-cash employee benefits such as health insurance, educational assistance benefits, and group legal services is unacceptable because it would increase the tax burden of the average worker while nothing is added to his or her earnings. In the case of unemployed workers enrolled in an employer-sponsored training program, for example, the imposition of income or FICA taxes would impose a forbidding out-of-pocket expense. Moreover, because they are provided as services, the taxation of each of these benefits presents what we believe are insurmountable problems of imputing taxable value in a fair and consistent fashion.

One other justification that has been offered for taxing employee benefits is that they have become "excessive" and helped to foster inflationary pressures in sectors of the economy such as the health care industry. This reasoning is simplistic and erroneous. As we will show later in our testimony, the inflation in the health care industry has multiple causes; workers having "too much" health insurance is not one of them.

I would now like to discuss in more detail some specific employee benefits.

Health Care Benefits

The expansion of employer health insurance plans since the end of World War II has been dramatic. The growth of group health insurance coverage among workers and their dependents has promoted wide access to health care, particularly throughout the non-elderly population. In 1979, more than 60% of the civilian population was covered by an employer group health plan; nearly 90% of full-time, year-round workers participated in an employer group health plan that year.[1] Coverage has reached beyond the higher-wage sectors of the workforce; the economies of scale associated with greater inclusion of workers in a group plan have encouraged the extension of health insurance coverage to lower-income workers.

This expansion of health insurance coverage, both in numbers and scope, has provided greater financial security and peace of mind to covered families. While the full array of benefits are not available to everyone and millions of people still lack effective access to the health care system, the expansion of health insurance coverage has benefited society as a whole, by contributing to the remarkable

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1. Cited in Employee Benefit Research Institute, "Testimony on the Tax Treatment of Employee Benefits," June 22, 1983.

improvement in the health of Americans, to their increased longevity, and to the countless breakthroughs achieved in the care and treatment of illness during the last three decades.

One important factor in this development, although by no means the only one, has been the tax-exempt status of employer-provided group health care benefits. The proposals to have workers pay taxes on the health insurance premiums paid by their employers threaten the integrity of existing health insurance plans and would adversely affect beneficiaries. Specifically, the proposal by the Reagan Administration that tax-free employer contributions be limited to $70 per month for individuals and $175 per month for families would be wrong because:

* It would create pressure to reduce negotiated health care benefits, to add copays and deductibles, and to drop various coverages (such as dental and vision care) from employee health benefit plans.

* It would penalize groups with more older workers who need to use more health care services. This in turn would discourage employment of older workers.

* It would act as an incentive for the younger, healthier workers in a plan to leave the plan, opting instead for reduced, inadequate coverage, and raising the cost of the plan to the remaining workers. The fragmentation of plans would add to the administrative costs of employers.

* It would penalize workers in higher risk occupations, such as assembly line workers, steel and foundry workers, and mineworkers.

* It would unfairly affect certain geographic regions because of variations in medical care costs in different areas.

* It would put pressure on employers and unions to reduce coverage for preventive health services. Such barriers to prevention and early treatment of illness could lead to increased use of high cost hospital inpatient facilities.

Taxation of health care benefits would impose substantial, unfair new taxes on working people. If the Reagan Administration's proposal had been enacted, many workers required to pay income taxes on employer premium payments in excess of the "cap" would have wound up paying federal income taxes in 1984 on more than 40% of the health insurance premiums paid by their employer. The tax cap proposal could have cost a worker with a family as much as $300 to $375 per year in increased taxes, equivalent to a cut of up to $7 in his or her weekly paycheck.

From the point of view of tax equity, the taxation of health care benefits would result in a more unfair after-tax distribution of income since employer costs for health insurance are relatively constant with respect to income levels.

The tax cap and other efforts to tax health care benefits would be ineffective in stemming the rapid rise in health care costs. Inflation in the sector is not due to too little cost sharing among workers. Most workers covered by health insurance are still exposed to substantial out-of-pocket payments for personal health services. UAW members employed by the major auto companies, for example, whose health insurance protection compares favorably with the broadest and most comprehensive coverage among American industrial workers, can expect to foot about 30% of their medical care bills on their own. Their program excludes almost all services (except surgery and emergency care) performed by doctors in their offices and requires significant patient copays for such items as prescription drugs, dental care and vision care services.

Inflation in the health care industry also cannot be attributed to the expansion of health insurance coverage. In fact, health insurance coverage practically ceased growing in the 1970s, while that period and the early 1980s have seen the greatest increases in health care prices along with increases in consumer out-of-pocket payments. It is hard to believe that if we had less coverage or more cost sharing the problems of the health care system would go away.

A careful look at the problem suggests that health care inflation has multiple causes including cost based reimbursement of hospitals, reasonable charge reimbursement of fee-for-service physicians, provider generated overuse of services, proliferation of for-profit health care providers, the introduction and spread of high-tech equipment, aging of the population, excess hospital capacity and the absence of any rational comprehensive cost control program. Taxing health care benefits does not attack these causes of inflation. Indeed, proponents of reducing insurance and increasing patient cost sharing fail to realize that:

1. There is no study which indicates that cost sharing has any long term effectiveness in reducing total health care costs. One only has to look to the federal Medicare program to see the ineffectiveness of cost sharing in controlling costs. Medicare has had extensive deductibles and coinsurance since its beginning in 1966, and both have increased over the years. Yet the cost of the program to the federal government has risen from $4.5 billion in 1967 to nearly $60 billion in 1984.

2. The effect of cost sharing on health status is uncertain. In fact, there is some evidence that patient cost sharing can serve as a barrier to early treatment and actually increase costs because more expensive treatment is required for conditions which have deteriorated due to postponement of care.

3. After the patient makes the decision to go to the doctor in the first place, virtually all decisions about what services are to be provided are made by doctors and other providers. Deductibles and copayments have been shown to have little effect on treatment decisions made by doctors.

- Consumers do not admit themselves to the hospital or arrange for their discharges, nor do they make the decision to stay in the hospital for an inordinate amount of time.

- Consumers do not write prescriptions for themselves, nor do they order an array of unnecessary tests and services for themselves.

- Consumers do not decide to build unnecessary hospital beds; neither do they decide to keep beds on line that should be closed down. It is not consumers who permit the continued existence of hospitals that should be closed.

- Consumers do not decide to acquire additional expensive equipment already available within the community.

4. Cost sharing has been shown to have almost no effect on the prices doctors and hospitals choose to place on their services. Providers decide the price of their services, not some free market.

5. The greatest increases in health care costs in recent years have been in the hospital sector. Yet patient cost sharing has been shown to have even less impact on use of hospital services than on other kinds of health care.

6. Patient cost sharing discourages access to care by lower-income persons. Study after study has shown that the burden of cost sharing falls inequitably on the poor, on blue collar workers, on minorities, and on those with large families.

In fact, the principal effect of patient cost sharing is to penalize consumers and to distract focus from the more politically difficult issue of holding our health care system accountable to public and consumer goals.

The cutbacks imposed by the Reagan Administration in federal spending for Medicare and Medicaid have not resulted in real health care cost containment. Rather, they have simply shifted costs to the private sector by raising Medicare deductibles, by requiring employers to provide primary coverage for older employees also covered by Medicare, and by allowing providers of care to pass along the burden of certain governmental "cost containment" efforts to private sector payers. The UAW and other unions have negotiated health insurance benefits for their active and retired members and their dependents which supplement Medicare coverage. When Medicare benefits are reduced there are no "savings"; there is simply a massive transfer of liabilities to individuals, insurers and private sector employers. In the case of private sector employers, the transfer of liabilities results in higher health insurance premiums over which neither the employer nor active and retired employees have any effective control. It is unconscionable that the Reagan Administration, which has been responsible for this massive cost shifting to the private sector, also proposes to tax the increased health insurance premiums that result from that shifted responsibility.

A more constructive and effective approach to the problem of rising health care costs is to begin the reform of the overall health care system. Ultimately such reform will be accomplished only under a comprehensive national health program. In the short-run, we favor an approach by which states would establish, within broad federal guidelines, "all payer" systems of prospective hospital reimbursement, negotiated fee schedules for doctors, and fixed diagnostic and laboratory fees. In addition, alternative forms of delivery, such as health maintenance organizations, should be encouraged. A serious example of such an approach is the proposed "Medicare Solvency and Health Care Financing Reform Act of 1984," which has been introduced by Senator Kennedy (S. 2424) and Representative Gephardt (H.R. 4870).

We urge this Committee to consider such legislation as a positive alternative to proposals to tax the health benefits of workers. It would begin to get at the root of the problem by containing escalating costs in the overall health care system through reduction of the inefficiencies and the excessive profits which characterize much of the health care industry. This would be of great benefit to all payers for health care services, including the federal Medicare and Medicaid programs, as well as to private employer-provided health insurance plans.

Retirement Plans

Like employer-provided group health insurance, employer-sponsored pension plans have greatly expanded since World War II. By 1983, approximately 43% of all employees participated in an employer-sponsored pension plan.[2] The growth of such pension plans has been due in large part to the efforts of the labor movement, which recognized that Social Security needed to be supplemented in order to insure that workers' retirement years would be free of financial worry. However, the tax deferred status accorded to pension contributions has also helped to encourage the establishment of funded pension plans — thus assuring workers a greater measure of security against the risk of poverty in old age, and creating a "safety net" whose benefits reverberate throughout the entire society.

In recent years the tax code has been modified in order to encourage the expansion of salary reduction or 401(k)-type plans, and so-called Individual Retirement

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2. Employee Benefit Research Institute Issue Brief #32, July 1984.

Accounts (IRAs), rather than the traditional employer-sponsored pension plans. These are very disturbing developments.

IRAs and salary reduction plans blatantly favor upper income individuals. In the case of IRAs, this is borne out by the results of a May 1983 survey conducted by the Census Bureau for the Employee Benefits Research Institute and the Health and Human Services Department.[3] Of the 16.7 million IRAs established in 1982, 50% were used by the 15% of all survey respondents earning above $25,000. Proportionately more than twice as many workers earning $50,000 or more contributed to IRAs as did workers earning between $20,000 and $50,000, and more than five times as many workers earning over $50,000 contributed to IRAs as did those earning between $15,000 and $20,000. By contrast, coverage under employer-sponsored pension plans is approximately the same for each of these groups: over $50,000, 74.4%; $20,000 to $50,000, 74.4%; $15,000 to $20,000, 63.7%. Salary reduction or 401(k)-type plans are also inequitable because they favor higher-paid employees: only employees who have discretionary income will participate, and those will typically be more highly-paid employees. In addition, contributions are allowed as tax deductions rather than tax credits, again benefiting those in higher tax brackets.

The dramatic expansion of IRAs and 401(k)-type plans has caused a considerable drain on the Treasury. After IRAs were expanded in 1981, the Office of Management and Budget estimated that tax expenditures for them and similar plans would increase by $2.1 billion from fiscal 1981 to 1983. In fact, the total jumped by $11.3 billion; and OMB now projects that IRAs alone will reduce revenues by $14.2 billion in the next fiscal year.

The UAW is also concerned about the growing trend of government policies which favor an "individual account" approach to employee benefits, such as IRAs or 401(k) plans, at the expense of traditional benefit plans. The UAW firmly believes

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3. Ibid.

that defined benefit plans meet workers' retirement needs better than other private-sector vehicles because they provide a predictable retirement income and do not subject participants to investment risks. Since benefits can be increased based upon service already accrued, adjustments can be made to take account of inflation both for active employees and for retirees. Flexible funding arrangements allow these costs to be paid over reasonable periods of time. While they are superior to other pension arrangements, defined benefit plans cannot be set up individually; thus the tax incentive provided for establishing these plans on a group basis clearly enhances social welfare.

The promotions of IRAs, which often "promise" to make younger workers millionaires by retirement age, have downplayed the interest-sensitivity of these projections and the impact that the inflation accompanying these interest rates would have on purchasing power. Unrealistic expectations engendered by such promotions could represent a widespread problem in the future.

Educational Assistance Benefits

The UAW is profoundly disappointed by the failure of Congress to re-establish the tax-exempt status of educational assistance benefits provided by employers as part of the tax legislation which was recently enacted. We believe the continuation of hundreds of programs to improve the education and skills of American workers is now in jeopardy. These programs not only help those directly involved; the public at large also benefits from higher productivity, a more dynamic economy, and a more equitable society.

The importance of these programs is underscored when we look at the massive dislocation of American workers that has occurred in recent years. Recession, import penetration, and technological change have taken an increasingly severe toll, causing an unprecedented number of workers to permanently lose their jobs. In addition, the skills of scores of thousands of active workers are quickly falling behind the demands posed by the new, redesigned jobs.

Within the UAW, our concern about re-employment opportunities for unemployed members and the uncertain occupational future that many currently employed members face has led us to give training and retraining a high priority in our collective bargaining agenda. Early in 1982 we established important new joint training programs with the Ford Motor Company and the General Motors Corporation.

Under both programs, the goal is to provide training, retraining, and developmental opportunities for active and laid-off UAW-represented workers. For laid-off workers, these programs provide invaluable assistance in seeking re-employment. For active workers, the programs have provided an opportunity to upgrade skills and enhance job security.

The response of our members has been enthusiastic. Close to thirty thousand workers have participated in the various educational, training and related programs. Taxing these benefits will discourage people from participating in the programs. For example, the federal income and FICA taxes of a laid-off GM assembler receiving unemployment compensation and negotiated supplemental unemployment benefits would go up 25% or about $150 for a single person, and 50% or about $115 for a person with a family, if the individual joined a company-sponsored training program, and this was treated as taxable income. Even if unemployed workers did not receive enough income to owe any income tax, they would still have to pay FICA taxes, something that most of them could not afford.

Moreover, for the unemployed as well as for people who enroll in training programs while holding a job, taxing these benefits would cut into their income at a time when they are already facing extra coursework-related expenses — for food away from home, child care, and/or an extra tank of gas. Groups in dire need of training opportunities, such as women and minorities, would be far less able to cope with these tax costs, and could fall even lower in the occupation and earnings ladder.

The inescapable conclusion is that taxing educational assistance benefits will severely curb participation in education and training programs, especially those geared to the unemployed, to the detriment of workers' chances for employment and career advancement. Efforts already in place, including costly buildings and equipment, will be utilized far below capacity or not at all. As a result, the entire economy will be shortchanged.

Failure to reestablish the tax-exempt status of these benefits means a return to the situation prior to 1978, when the IRS required that employer-reimbursed tuition assistance relate solely to present job responsibilities in order to merit tax-exempt status. This will result in benefits being confined mostly to upper-income individuals in executive and management positions, and will clearly restrict the availability of benefits to rank and file workers.

In addition, taxation of educational assistance provides many American workers with a disincentive to invest in their own human potential, in stark contrast to the incentives that the tax code lavishes on business for investment in plant and equipment.

Taxation of educational assistance cannot be defended on grounds of revenue loss: its current impact on the deficit is very small. Indeed, as a matter of revenue policy, taxation of educational benefits seems woefully shortsighted. It makes much more sense to subsidize education and training now, and tax the resulting higher incomes in the future; in effect, we are not talking about tax exemption as much as about tax deferral, on higher future earnings.

<u>Group Legal Service Plans</u>

The UAW has long been a supporter of group legal service plans. In our view, they represent the best means of making quality, low cost legal services available to average working men and women. Traditionally, legal services have been available in this country only to the top and bottom segments of society. The wealthy and powerful can afford to hire the best law firms. And the very poor are provided free representation through legal aid offices. Average middle class Americans have been left out in the cold.

This situation began to change because of a number of developments in the late 1960s and 1970s. An important one was the addition of Section 120 to the Internal Revenue Code in 1976, making it clear that employer contributions to and services provided under qualified group legal service plans do not constitute taxable income to employees.

That tax change removed an obstacle, and the UAW and other labor unions increasingly began to take an interest in negotiating group legal service plans as a means of assuring that their members have access to quality, low cost legal representation.

The UAW now has approximately 630,000 active employees and retirees, along with their families, covered under negotiated group legal service plans. The response of our membership to the programs has been enthusiastic. They have expressed satisfaction with the quality of the legal services provided by the programs. And our members have indicated that they consider group legal services to be an important and valuable fringe benefit which they are interested in preserving and expanding.

The types of legal problems handled by our group legal service plans are diverse. The consumer-debtor services have proven to be especially important for our membership, which has faced financial pressures as a result of layoffs and the recession. The real estate and probate services have also proven to be valuable. By making these legal services readily accessible to our members, they have often been able to obtain legal advice before serious problems have arisen.

The UAW remains committed to the growth and development of group legal service plans which can provide quality, low cost legal services to our members. However, the continued growth and viability of group legal service plans would be obstructed by termination of their tax-exempt status embodied in Section 120 of the Internal Revenue Code.

Section 120 is currently scheduled to expire on December 31, 1984. If it is not extended, the acceptability among employers and unions of new group legal service plans will be seriously undermined. Worse, the continued operation of existing plans will be jeopardized.

Keeping the tax-exempt provisions for group legal plans will not cause any serious revenue loss for the federal government. The Joint Committee on Taxation has estimated that the tax expenditure associated with Section 120 amounted to only $20 million in 1982. Even assuming that the number and size of group legal service plans were to grow considerably in the future, because such plans are relatively inexpensive, the tax expenditure still would not be of sufficient magnitude to warrant concern.

In order to encourage the continued development and growth of group legal service plans, Congress should now act to make Section 120 permanent. We commend you, Mr. Chairman for introducing S. 2080, which would make Section 120 permanent. We urge this Committee to act promptly to approve this important legislation. This will give employers and labor unions the assurance they need in the long term viability of group legal service plans in order to make a major commitment to such programs in collective bargaining. In turn, it will help make legal services available to millions of middle class Americans.

Funded Welfare Benefit Plans

For about two decades, most UAW members have been covered by contract clauses providing for supplemental unemployment benefits when they get laid off. These cash benefits have cushioned the impact of cyclical or seasonal unemployment on our members, as well as the communities where they live. While SUB benefits are taxable income to employees, the total contributions made by the companies to the SUB funds have always been tax deductible.

The Tax Reform Act of 1984 limits the deductibility of employer contributions to voluntary employee beneficiary association (VEBAs), supplemental unemployment benefit (SUB) plans, and prepaid legal service plans. We understand that Congress acted because of concern about various abuses associated with "pre-funding" of top-heavy plans by professional corporations. The UAW strongly supports curbing those abuses. However, since no abuses have been documented in connection with collectively bargained plans, there was no jusification for extending the funding limits to these plans. As currently structured, the funding limits could have an adverse impact on our SUB plans, because they are not sensitive enough to accommodate the wide cyclical swings in SUB payouts. Specifically, these limits could prevent employers from being able to make sufficient contributions to the SUB plans so that sufficient reserves are built up to pay benefits during future recessions.

The recent history of the UAW-GM SUB plan demonstrates the need for substantial reserves and the adverse impact of the new restrictions. In July 1979, the UAW-GM SUB plan had assets of $443 million. By September 1980, the auto crisis had caused the balance to shrink to $30 million. Under the new law, the funding limits would now restrict the UAW-GM SUB plan to just $367 million, despite the fact that during the preceding seven years which can be taken into account in calculating the funding limits, there were two years (1980 and 1982) when the plan paid out almost $1 billion. Worse yet, by 1990 — when neither 1980 nor 1982 can be counted in calculating the funding limits — the UAW-GM SUB plan could be restricted to a potentially inadequate reserve of $150 million.

During the recent depression in the auto and farm implement industries, the existence of large reserves in our SUB plans not only spared many UAW families from destitution, but also cushioned the shock on numerous communities throughout the country which were hit hard by massive layoffs and plant closings. Thus, the new limitations on the funding of SUB plans could have an adverse impact on the general public, as well as UAW members.

Under the new law, the Treasury Department is required to promulgate regulations by July 1, 1985, establishing special reserve limits for collectively bargained plans. We urge Congress to closely monitor the actions of the Secretary, to insure that collectively bargained plans are in fact accorded sufficient flexibility in their funding arrangements.

Conclusion

Mr. Chairman, this statement has focused upon a number of important employee benefits, pointing out that they warrant favorable tax treatment because of their merits, the role they play in the lives of broad groups of people, and the non-cash form in which they are paid. There are other employee benefits which I have not discussed due to space limitation, but which are also supported by the UAW. For example, well designed employer sponsored child care programs can provide desirable mechanisms and economies not otherwise available to most working people. They deserve to be encouraged through the tax laws because they accomplish a function not fulfilled by the current tax credit allowed to individuals for child care expenses.

On the other hand, the UAW supports stringent rules against top heavy fringe benefit plans and limits on the amount of pension or severance payments which are tax exempt. Fringes which merely reduce taxable income for those who are already well off and paying less than their fair share of taxes should not receive favorable tax treatment.

The UAW is concerned about the size of federal deficits and supports efforts to raise taxes to reduce them. The attached UAW tax program sets out in detail sources of revenue that would bring in substantial funds, while increasing the progressivity of the tax code and the share of taxes paid by corporations. In the search for higher revenues, the employee benefits I have discussed should be the last source tapped, on the basis of the protection they afford to those covered, their positive impact on society and the fact that no federal action seems to be forthcoming in the near future to take their place.

We have appreciated the opportunity to present our views concerning the taxation of fringe benefits. We urge the Committee to give them careful consideration in any future actions relating to the tax status of various employee benefits.

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UAW Tax Program

Taxation of Individuals	Additional Revenues Fiscal Year 1985
o Cap the third year of the 1981 tax cut at $700	$ 6.9 billion
o Repeal indexation of tax brackets scheduled to begin in 1985.	6.2
o Restore the estate and gift tax, which was largely repealed by ERTA.	2.1
o Change IRAs from a deduction to a credit, to provide the same dollar amount of savings to all "savers" regardless of tax bracket.	3.7
o Phaseout of capital gains preferences. The exclusion should be cut back to the pre-1979 level of 50 percent, and a phasedown begun to totally eliminate this preference over a 5-year period. Special provisions to protect homeowners should be enacted. Capital gains preferences for investing in gold, collectibles, and other nonproductive assets should be eliminated outright. The provision in the Tax Reform Act of 1984 that reduced the long-term capital gain and holding period from one year to 6 months should be repealed.	3.9

Taxation of Corporations

If the corporate income tax were to bear the same share of the federal tax burden in 1984 as it did as recently as 1980, receipts would almost double. One way to move in that direction is by adoption of a minimum tax for corporations. Other measures toward the same goal include:

o Phase out tax preferences related to foreign operations. Foreign taxes should be treated just like other costs of doing business. Right now, foreign tax credits allowed on a dollar-for-dollar basis against a multinational company's U.S. income encourage U.S. corporations to export jobs and to produce abroad. Multinational corporations should not be allowed to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such profits are brought home. The recently enacted Foreign Sales Corporation provision that allows deferral of taxes on export profits is no improvement over the DISC it replaced and like DISC amounts to a wasteful and costly tax expenditure.	9.5

o Eliminate tax breaks for the oil industry. Oil depletion allowances and write-offs for intangible dwelling costs have no economic justification. They favor both major oil companies and so-called independent producers, and provide a generous tax shelter to the income of highly-paid individuals. 6.0

- Allow the Research and Development Credit for Incremental Research and Experimentation Expenditures to expire at the end of 1985. The preferable approach is for the federal government to target assistance through a NASA-type agency, so that there is assurance that the new technologies which are fostered will lead to job-creating investment in the U.S. 1/

- Attach meaningful strings to investment incentives. The UAW has long advocated the repeal of across-the-board investment incentives. Most often, they become a windfall for companies that would make the investment anyway. Instead, we support targetted federal relief. Either directly or through the tax system, federal help would be made available to those companies, industries, and regions which need it most and which agree to commit themselves to desirable actions with respect to employment levels, location of facilities, labor standards, etc. While this shift takes place, there should be curbs on the revenue drain related to the investment tax credit and accelerated depreciation schedules. In particular:

- End double-dipping on the investment tax credit. Since 1981, accelerated depreciation write-offs have been allowed on the entire purchase price of new equipment, although as much as 10 percent of the price is offset by the investment tax credit. In 1982, Congress disallowed accelerated depreciation deductions for half the value of the investment tax credit. That job should be finished by allowing depreciation deductions only after the full amount of the investment tax credit has been subtracted. 1.3

- Stop tax inducements for mergers and acquisitions. Companies should not be allowed to take advantage of the unused tax breaks of firms they acquire. Deductions of interest paid to finance unjustified corporate mergers and acquisitions should also be disallowed. 2/

1/ None in fiscal 1985, but substantial savings in future years.
2/ Not available.

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Senator PACKWOOD. Both you and Mr. McGlotten touched upon the education benefits. I thought that Bill Raspberry had a good column on it yesterday, which is right to the point. We are in an ironic reverse situation. With the expiration of the law that says that all education benefits were nontaxable, we have gone back to the old law. This means education benefits are not taxable if they are related to the performance of your present job. They are taxable if they are to improve yourself so that you might get a better job.

But the irony of that is there is hardly a course imaginable that you couldn't justify as necessary to perform your present job, if you are a high level employee. But for the poor devil that drops out of high school at 16, is working in the tool cribs, and now he has got to learn how to use a computer, and the employer is willing to pay for it, that is an advancement. These are the people that are going to have to pay taxes on the education. The employer is going to have to withhold it. I know what the employer is going to say, and especially if it is a small employer, it just isn't worth it if we have got to withhold it and they have got to pay taxes. This is one benefit that has expired where we have really favored the rich, whether they work in union management positions or employer management positions. We have said for anybody that is basically at the bottom end of the scale, tough luck.

Steve, you wanted to say something?

Mr. KOPLAN. I was just going to comment, Mr. Chairman, that we are hoping that perhaps at some point before this session ends that whole issue can be revisited. Certainly, seeing both you and Chairman Dole here, we are not unmindful of the fact that had the conferees adopted the Senate provision we would not be in this position now. So, we are appreciative of both of your efforts in this regard, and we hope the ball game is not over.

Senator DOLE. Could we tack that on to reciprocity? [Laughter.]

Mr. KOPLAN. Well, we will talk about that at a later time.

Senator PACKWOOD. I think they would prefer to play a double header, instead of just one game. [Laughter.]

Mr. Tiner.

STATEMENT OF MICHAEL L. TINER, ASSISTANT DIRECTOR OF GOVERNMENT AFFAIRS, UNITED FOOD & COMMERCIAL WORKERS INTERNATIONAL UNION, WASHINGTON, DC

Mr. TINER. Thank you, Mr. Chairman. My name is Michael Tiner, and I am the assistant director of government affairs for the United Food and Commercial Workers International Union I would like to take this opportunity to publicly express the gratitude of the UFCW, to Chairman Packwood for his leadership and assistance in the area of fringe benefits during consideration of the recent tax bill. Millions of American workers benefited directly from the chairman's expertise and efforts. Turning to the subject of these hearings now, the basic position of the UFCW is that we strongly urge the Congress to look at areas other than fringe benefits to raise revenues. Congress provided the statutory exclusion for certain fringe benefits because it believed that the benefits provided were sufficiently important to warrant encouragement. Encouragement was provided in the form of the statutory incoming exclusion. The UFCW believes that nothing has changed to merit the withdrawal of the congressional encouragement needed to continue to provide these statutory exempt fringe benefits. We realize that there will be strong pressures to raise revenues to offset the huge deficits created by the tax giveaways in 1981, and we suggest that Congress look at those who benefited most in 1981 to now begin to share in the cutting of deficits. The tax reform bill of 1984 only partially addressed the question of taxing fringe benefits and did not resolve all of the problems in this area. For example, the statutory exclusion for education assistance was not renewed. As the committee is well aware, this worthwhile program was allowed to lapse because an agreement could not be reached on whether FICA and FUTA taxes would be paid on this benefit. The UFCW opposed efforts to impose FICA and FUTA taxes as the price for excluding educational assistance from the withholding tax. Additionally, the tax reform bill did not address the need to extend from the income exclusion legal services. We believe that the current tax treatment of qualified group legal services has helped in encouraging the use and protection of these plans at minimal cost. Accordingly, we are pleased to endorse Senator Packwood's S. 2080 making permanent section 120 of the Internal Revenue Code and thus continuing to encourage qualified group legal service plans. We sincerely hope that the efforts of the chairman to enact this 2080 won't fall prey to the same fate as the statutory exclusion on educational assistance. The UFCW is opposed to the imposition of FICA included taxes on group legal service benefits. It is our opinion that the attempts to have FICA included in educational assistance is a harbinger of things to come, not only in group legal services but on the health and welfare plans as well. Attempts to cap or limit the amount of tax-free health insurance workers enjoy are not new or innovative. However, prior to our current deficit problems, these attempts were billed as a means of controlling rapidly rising hospital costs. Now, to help pay for the excesses of the 1981 tax cuts for the wealthy, workers are expected to help balance the budget by allowing Congress to tax their fringe benefits. It is the UFCW's position, Mr. Chairman, that there cannot be any real cost containment until the providers and suppliers of services have strong financial incentives to change. We urge the committee to ask itself whether health care is the right place to look for ways to reduce the deficit.

In closing, let me say we look forward to working with the chairman in attempts to come up with a fair and equitable plan to reduce the current deficit problem. Thank you.

Senator PACKWOOD. Thank you, Mike. Ms. Johnson?

[Mr. Tiner's prepared statement follows:]

UFCW

Arnold Mayer
International Vice President
Director of Government Affairs

STATEMENT BY MICHAEL L. TINER

ASSISTANT DIRECTOR OF GOVERNMENT AFFAIRS

UNITED FOOD AND COMMERCIAL WORKERS INTERNATIONAL UNION (AFL-CIO)

PRESENTED TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE COMMITTEE ON FINANCE

UNITED STATES SENATE

JULY 26, 1984

My name is Michael L. Tiner. I am Assistant Director of Government Affairs of the United Food and Commercial Workers International Union (AFL-CIO).

The UFCW is a labor union with 1.3 million members organized in some 600 local unions throughout the United States and Canada. The UFCW and its local unions have collective bargaining agreements with tens of thousands of employers throughout the food processing, retail sales, fur, leather, health, commercial, shoe and other industries.

Before getting into our testimony, I would like to take this opportunity to publicly express the gratitude of the UFCW to Chairman Packwood for his leadership and assistance in the area of fringe benefits during consideration of the recent tax bill. Millions of American workers benefited directly from the Chairman's expertise and efforts.

Turning to the subject of these hearings, the basic position of the UFCW is that we strongly urge Congress to look at areas other than fringe benefits to raise revenues.

William H. Wynn
International
President

Anthony J. Lutty
International
Secretary-Treasurer

Government Affairs
Direct Line
(202) 466-1560

United Food & Commercial Workers
International Union, AFL-CIO & CLC
1775 K Street, N.W.
Washington, D.C. 20006
(202) 223-3111

Congress provided the statutory exclusion for certain fringe benefits because it believed that the benefit provided was sufficiently important to warrant encouragement. Encouragement was provided in the form of a statutory income exclusion.

The UFCW believes that nothing has changed to merit the withdrawal of the Congressional encouragement needed to continue to provide these statutory exempt fringe benefits.

We realize that there will be strong pressures to raise revenue to offset the huge deficits created by the tax giveaways of 1981. We suggest Congress look to those who benefited most in 1981 to now begin to share in the burden of cutting the deficit.

In 1979, the AFL-CIO Convention set forth some general principles with respect to the taxation of fringe benefits on which Congress should base its actions in the area of fringe benefits.

1. Sensible "de minimis" rules should be written so that employers and employees need not take into account small benefit values which would cause unreasonable record keeping and administrative burdens.

2. Benefits that facilitate the employee's work performance, are provided for the convenience of the employer, or other support services, such as the furnishing of uniforms, should not be taxed.

3. Limited benefits historically and broadly available such as discounts for employees of retail stores should be exempted from taxation.

4. Provisions of present law, which under specified conditions expressly grant tax exemptions for fringe benefits including, among others, qualified pension plans, group life insurance, health benefits and group legal services should be continued.

As the members of the Committee know, the Internal Revenue Service for several years was by statute prohibited from issuing rules regarding the taxation of fringe benefits. However, in the Tax Reform Act of 1984, the moratorium was replaced with specific statutory language. The provisions of H.R. 4170 relating to taxation of fringe benefits represents a fair and equitable approach to the thorny question of taxing fringe benefits. We were pleased to support that section of the tax bill.

The Tax Reform Bill of 1984 only partially addressed the question of taxing fringe benefits and did not resolve all of the problems in this area. For example, the statutory exclusion for education assistance was not renewed. As the Committee is well aware, this worthwhile program was allowed to lapse because an agreement could not be reached on whether FICA and FUTA taxes would be paid on this benefit. The UFCW opposed efforts to impose FICA and FUTA taxes as the price for excluding educational assistance from withholding tax.

Additionally, the Tax Reform Bill did not address the need to extend the income exclusion on group legal services.

Since Congress amended the Taft-Hartley Act in 1973 to permit the use of employee benefit trusts to provide legal services, it has acted twice to extend the income exclusion. In 1976, Congress extended Section 120 for five years, and in 1981, it was extended for three years. The UFCW believes that the current tax treatment of qualified group legal services has helped in encouraging the use and protections of these plans at minimal costs.

Accordingly, the UFCW is pleased to endorse Senator Packwood's S. 2080 making permanent Section 120 of the Internal Revenue Code and thus continuing to encourage qualified group legal service plans.

Although legal service plans exhibit considerable diversity in structure, cost and benefits, all plans help remedy the unmet legal service needs. Recent studies show that some 35 percent of the population encounters some problems that could be solved by a lawyer, but only 10 percent actually seek legal assistance. By contrast, an average of 20 percent of covered employees in a group plan obtain legal assistance. It is important to point out that for the most part these covered employees are receiving preventive legal services that often make it possible to avoid litigation or protracted remedial services.

Although we were unable to determine the total number of UFCW locals currently providing group legal service benefits to members, we have identified three UFCW locals that provide this benefit. These examples will illustrate the benefit that this program provides:

1. In the Paterson, New Jersey area, UFCW Local 464A provides free group legal services for approximately 6,500 UFCW members. As the result of recent negotiations, an additional 3,000 members will begin receiving group legal service benefits August 1, 1984. Local 464A was the first New Jersey local to negotiate group legal services having negotiated this benefit for its members in 1976.

2. In the Detroit metropolitan area, UFCW Local 876's group legal service plan provides free legal services to approximately 14,000 of its members.

3. In the metropolitan Washington, D. C. area, UFCW Local 400 has a legal service plan th provides free legal services to approximately 18,000 employees of two area retail chains and their families. An additional 10,000 members and their families, who are not employed by these two chains, qualify for reduced cost legal services by virtue of their membership in Local 400.

By making advance arrangements on a group basis, the time, cost and uncertainty involved in selecting and consulting a lawyer when a legal question arises is dramatically reduced. Thus, though the people covered by a plan tend to contact a lawyer more often, they also do so at an earlier point in the course of a problem. As a result, more people receive legal advice, matters are handled at lower cost and, in a way, that minimizes disputed litigation.

The legal services provided by plans are those most often needed by average citizens, starting with initial legal consultations, advice and routine follow-up, and continuing through routine matters such as wills, divorces, real estate transactions, consumer matters and so on, depending on the level of plan funding. Most plans attempt to provide reasonably generous benefits in case the individual is sued in civil court. Some plans provide some coverage in criminal cases. Traffic and misdemeanor matters are more often covered than felonies. Sometimes only the emergency stages (arraignment and bail) of criminal matters are covered. Plans generally tend not to cover matters subject to contingency arrangements, such as personal injury and probate cases. Some plans cover court costs and other litigation expenses. Almost all plans cover both the employee and his family. Coverage for retirees is also frequently provided. Although legal service plans fill a real and important need, their cost is modest.

According to the Joint Committee on Taxation, the annual revenue loss associated with qualified group legal service plans is $25 million. It is likely that if Section 120 were made permanent, the figure would grow as more poeople are covered. Nevertheless few sections of the tax code have so clearly achieved their objective at such a low cost. We believe that workers should not have to pay taxes on employers' contributions to qualified legal service plans.

We sincerely hope that efforts of the Chairman to enact S. 2080 will not meet with the same fate as the statutory exclusion on educational assistance.

The UFCW is opposed to the imposition of FICA and FUTA taxes on group legal service benefits. It is our opinion that the attempts to add FICA and FUTA to educational assistance is a harbinger of things to come not only on group legal services but on health and welfare plans as well.

Attempts to cap or limit the amount of tax-free health insurance workers enjoy are not new or innovative. However, prior to current deficit problems, these attempts were billed as a means of controlling rapidly rising hospital costs. Now to help pay for the excesses of the 1981 tax cuts for the wealthy, workers are expected to help balance the budget by allowing Congress to tax their educational assistance program, their group legal service program and their health and welfare program.

Those who advocate taxing health and welfare contributions understand neither collective bargaining or the health care market. If reductions in benefits are required due to the imposition of a health tax, what would be dropped from plans are coverage for preventive care, dental, optical and other benefits which save workers money. What would be left untouched is coverage for hospital and surgical benefits which have been the major source of our health inflation problems and represent a problem over which users have very little control.

We have several other problems with attempts -- whether under the guise of cost containment or deficit reduction -- to limit tax exempt contributions. They are:

1. Worker benefits negotiated through collective bargaining should not be subject to the vagaries of the tax code, which force distortion in coverage and encourage circumvention of the process.

2. Workers in high cost areas will be severely penalized by a national cap.

3. Employees with chronic conditions and older workers will be forced to purchase expensive supplemental insurance.

4. The proposal will discourage hiring of older workers and those with higher health care costs.

5. The proposal discriminates against workers in unhealthy industries, such as coal and steel, where health care costs are higher.

6. The plan would be almost impossible to administer for the self-insured. Since they do not pay premiums, it would be difficult for tax purposes to determine monthly employer contributions.

7. The proposal would require opening up large numbers of existing labor contracts, while the issue of whether the proposal will reduce overall health costs is, at best, open to question.

It is the UFCW's position, Mr. Chairman, that there cannot be any real cost containment until the providers and suppliers of services have strong financial incentives to change. We urge the Committee to ask itself whether health care is the right place to look for ways to reduce deficits.

In closing, let me say that we look forward to working with the Chairman in an attempt to come up with a fair and equitable plan to reduce the current deficit problems.

# # #

STATEMENT OF LORETTA JOHNSON, VICE PRESIDENT, THE AMERICAN FEDERATION OF TEACHERS, AFL-CIO, WASHINGTON, DC

Ms. JOHNSON. Mr. Chairman and members of the subcommittee, I am Loretta Johnson, vice president of the American Federation of Teachers. Thank you for the opportunity to testify on this issue relating to the taxation of fringe benefits. Thank you also for your leadership and your efforts and those of the other committee members and Senate conferees to protect the status of educational benefits. I would like to summarize my statement as one of the participants in an educational program, that led to a career ladder, a B.A., and the status of a teaching certificate. The group that I represent are paraprofessionals and school-related personnel. They are of very low economic status—$8,000 to $10,000 in income coming into their homes. The majority of them are women, minority group members and heads of household.

Without educational upgrading programs, there is no place for this group of employees to go. They cannot take advantage of such a program if taxation is added to it. They already face the problems of keeping a household, watching children, and at the same time working a full-time position. I would like to give you some of the experiences that have happened around the country.

In New York City, 200 paraprofessionals who were involved in an educational program have been upgraded for the coming year through the career ladder program to teacher status and will help a teacher shortage in the handicapped area. In Baltimore, my own city, we have 25 paraprofessionals going into the teaching profession in Baltimore City because of an upgrading program without taxation. The paraprofessionals in Philadelphia have also been upgraded to a level from $6,000 to $12,000 in income through career credits programs. We have in Baltimore a 2-year free educational program—for AA degrees—that upgrade the employees to other fields—lab technicians—and allow them to go into other educational programs. Mr. Chairman, it has been my intent to offer a few examples of the importance of reestablishing the section of 127, Employee Educational Benefits. I believe this is a necessary task because the benefits serve many useful social purposes. Because dropping the benefits has discriminatory consequences, and because we are once again in a state of confusion on this issue. I will be happy to respond to any questions that you have.

[Ms. Johnson's prepared statement follows:]

TESTIMONY BY
LORRETTA JOHNSON
VICE PRESIDENT
AMERICAN FEDERATION OF TEACHERS
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE

July 26, 1984

Mr. Chairman and members of the subcommittee, I am Lorretta Johnson, Vice President of the American Federation of Teachers. Thank you for this opportunity to testify on issues relating to the taxation of fringe benefits. Thank you also for your leadership and effort, and the efforts of other committee members and Senate conferees, to protect the status of education benefits.

Fringe benefits often provide services to employees, particularly those of modest income, which they are unable to provide for themselves. Consequently, fringe benefits often improve the quality of society for all of its members. It is to my benefit that my neighbor is more secure, has better health protection, and is more fully educated.

Recently Congress allowed Section 127 of the federal tax code to expire. Senate and House conferees were unable to reach agreement on an extension because the House insisted on some form of taxation on this vital fringe benefit. The AFT supports the position taken by Senate conferees that allow F.I.C.A. and F.U.T.A. taxes to be imposed on employee educational benefits would set an ominous precedent.

In its effort to address the urgent problem of the federal deficit, Congress overlooked important social and economic consequences of the employee educational assistance program. This benefit has served to strengthen educational institutions, to alleviate shortages in public services, to improve integration and the status of minorities, and to relieve serious dislocations in the job market. In addition, the demise of the tax-free status of employer provided education assistance has discriminatory impact on minorities and the economically disadvantaged. The plain facts are that low income employees will have to come up with dollars they don't have in order to accept and then pay taxes on educational benefits. Those who are more affluent will be able to pay taxes and therefore use such benefits. Social security taxes, in particular will have a regressive impact - often being escaped by those with higher incomes.

Further, the expiration of Section 127 seems to be short-sighted as tax policy. While we can only guess the consequences in terms of tax revenue it seems a safe bet that far greater revenue would be achieved in the long run by encouraging employees to raise their education levels and earn higher incomes. Finally, the demise of Section 127 places employees and their representatives in a state of confusion. We know of no concise and clear definition of "job relatedness" concerning employer-provided education benefits. It is unwise tax policy to knowingly foster such confusion.

I should like to present some examples which illustrate how employee educational assistance has helped strengthen educational institutions and has served other important social purposes.

New York City schools have been wrestling with the problem of a critical shortage of teachers. In part, this shortage has been met through a "career ladder" negotiated for paraprofessionals by their union, the United Federation of Teachers. It is important to understand that paraprofessionals and classroom or teacher aid positions are low-paying jobs, typically held by minority-group members. In New York City paraprofessionals earn an average of about $8,000 per year; education associates, occupying similar positions, earn approximately $10,000.

The career ladder has allowed hundreds of paraprofessionals, over the years, to obtain college degrees and teaching certificates by means of education paid for, at least in part, by the school board. Each paraprofessional has available from the board $240.00 per year for college course work. Recently, the union and the school board cooperated in a special effort to expedite the certification of more than 200 paraprofessionals as teachers for the coming school year. Many of these have special expertise in education of the handicapped.

A union spokesperson estimates there are currently more than 2000 teachers in the New York school system who previously were paraprofessionals receiving employee educational assistance. The career ladder program not only helped meet the shortage of qualified teachers but also helped produce qualified minorities for the teaching force.

In Baltimore, because of a union negotiated provision, paraprofessionals in the school system are provided two years of free college education. By achieving an A.A. degree they advance on the salary schedule, and, appropriately, pay more income taxes. This year, twelve or thirteen paraprofessional who have used the employee education benefit have become teachers in the Baltimore system. I believe the employer provided education benefit has been very instrumental in giving paraprofessionals a push up the ladder.

Philadelphia paraprofessionals and non-teaching assistants participating in a union-negotiated plan were provided full tuition, books, and supplies for up to six college credits this year. The average cost is $828.00 for the 157 participants. Paraprofessionals range from $6,000 to $12,000 in salary; non-teaching assistants range from $8,000 to $16,000. According to a union spokesperson, several hundred paraprofessionals or assistants have earned college degrees and become teachers. Most paraprofessionals are minority-group members, so this mobility has helped improve the racial balance of the teaching force.

In Hartford, the school board pays for up to six credits per year for paraprofessionals at any college or university. Usually the courses must be in preparation for a career in education. The highest salary earned by paraprofessionals without college credits is $9,000 per year. The average cost for the educational benefit is about $720.00 per year. Approximately 60 percent of the paraprofessionals are black, 24 percent are Hispanic.

A representative of the Hartford Federation of Teachers reports that over the past two years approximately 25 paraprofessionals have become teachers. All but one of these was a minority-group member. Again, the employee education benefit has helped integrate the teaching force.

Florida's United Teachers of Dade County reports that hundreds of paraprofessionals have used the employee education benefit to obtain teaching certificates. In addition, thousands of teachers have used the benefit to upgrade their teaching skills. Under the program, up to $50.00 per credit hour is provided for courses leading to a BA degree, and up to $150.00 per credit hour for advanced degree work. The average income of paraprofessionals is under $10,000 per year; the medium income of teachers is $23,000. As a result of the benefit program, the expertise of the teaching staff has been improved, as has the integration of the teaching staff.

The Illinois Federation of Teachers reports that in Cahokie school secretaries used an employee education assistance program to obtain first-aid training. The school system was reluctant to approve this type of training, at first. However, there was a serious shortage of school nurses. Paraprofessionals and classroom aids used the program to obtain training in special techniques for helping handicapped students. This helped reduce the shortage of qualified aides in special education. School employees are allowed $125.00 per course, which is the amount of tuition at a local university. Thus, the benefit is not sufficient to cover books, transportation, meals, and other incidental expenses.

In Michigan, teachers represented by the Highland Park Federation of Teachers are allowed $40.00 per credit hour for college course work approved by the school district. Highland Park, like school districts across the nation, is faced with a shortage of math and science teachers. Recently, the Highland

Park district paid for five teachers to earn masters degrees in mathematics. As you know, the Senate recently passed legislation to fund teacher training in science and math in order to meet the national shortage.

The social benefits of employee education assistance are not confined merely to upgrading and retraining within the field of education. We know that thousands of workers must be retrained each year due to layoffs and other dislocations in industry. There is a certain irony in expecting an unemployed worker to pay taxes on employer-funded retraining. However, I will leave it to other witnesses to talk about those issues. I will mention that registered nurses and medical technologists represented by the Staff Nurses Council, an AFT affiliate in Milwaukee County, have an employee education assistance program which provided each participating member with approximately $600.00 last year for educational expenses. The funds were expended for such purposes as retraining medical technologists and upgrading nurses to the B.A. level. Given the rapid development of advanced technology in health services, I believe this type of program serves an important public function. Needless to say, such employees do not generally earn high salaries.

Higher education is another realm in which ending the moritorium on taxation of employee education benefits will have a very deleterious effect. At the University of Michigan graduate teaching and research assistants reportedly are facing a combined additional tax liability of over $800,000 this year due to tuition waivers. In some cases this will amount to more than

$1,000 of extra tax liability per student. Typically, graduate assistants barely survived, as it was, on the stipends earned while pursuing their studies. Few universities have the funds to increase stipends sufficiently to absorb this additional taxation. We must expect that the demise of Section 127 tax benefits will have a very depressing effect on graduate training programs and, hence, university teaching and research.

Another example is offered by the State University of New York. The S.U.N.Y. system has 3,450 graduate teaching or research assistants receiving waivers for the $2,150 tuition fee. They also receive an average stipend of $5,000 per year. A spokesperson for the United University Professions said the new tax liability will make it very difficult to maintain the same quality of graduate programs. S.U.N.Y. also has an empoyee tuition program for community college employees attending the university. This is viewed as an important program for upgrading teaching staff and for retraining staff to avoid layoffs. Last year 1,865 employees used the program.

S.U.N.Y. additionally has a "space available" program for staff. It is very important to the university in helping adjust to its shifting labor force needs. Under this program $500,000 in benefits are available each year for those threatened by retrenchment. S.U.N.Y. has a "tuition waiver" program which is available to teachers doing advanced degree work in exchange for supervision of student teachers. This program is of great importance in meeting the rising shortage of teachers.

At Henry Ford Comminity College in Michigan a $30,000 fund will be availble next year to help the staff pursue additional education. As it is, the costs of pursuing advanced degree work are not areset by the slight salary increases received. Acordingly, the college administration and the union agreed that some additional incentive is necessary. Advanced degree work by the staff will improve the overall college program and will allow retraining and retaining of faculty faced with layoffs in their current subject areas.

Mr. Chairman, it has been my intent to offer a few examples of the imortance of re-establishing the Section 127 employee education benefit. I believe this is a necessary task because the benefit served many useful social purposes, because dropping the benefit has discriminatory consequences, and because we are once again in a state of confusion about "job relatedness." I will be happy to respond to any questions.

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Senator PACKWOOD. Ms. Johnson, you are living proof again of the value of actual examples. We have all got theoretical experience and we all look at things in the aggregate. We know how many thousands of people are helped, but it is very helpful to have somebody come and say let me give you one example—I am one. I appreciate it. Thank you.

Mr. DeConcini?

STATEMENT OF JOHN DeCONCINI, CHAIRMAN OF THE BOARD OF TRUSTEES AND INTERNATIONAL PRESIDENT OF THE BAKERY, CONFECTIONERY, & TOBACCO WORKERS INTERNATIONAL UNION, ACCOMPANIED BY JAMES C. HOUSTON, VICE PRESIDENT, ADMINISTRATION, ITT CONTINENTAL BAKING CO., RYE, NY, ON BEHALF OF THE BAKERY & CONFECTIONERY UNION AND INDUSTRY INTERNATIONAL HEALTH BENEFITS & PENSION FUNDS, KENSINGTON, MD

Mr. DECONCINI. I am John DeConcini, president of Bakery, Confectionery and Tobacco Workers International Union, AFL-CIO. Seated next to me on my right is James Houston, vice president of ITT Continental Baking Co. We are respectively chairman and secretary of the Bakery and Confectionery Union and Industry International Health Benefits and Pension Plans. We very much appreciate this opportunity to testify before this committee on the subject of fringe benefits. Our plan covers 41,800 bakery—our health plan—and confectionery workers and their families in 39 States in the United States.

Our pension plan covers 80,000 workers in 46 States. There are 1,790 contributing employers to one or more of the plans ranging in size from the largest baking company to small, one- and two-person retail bakeries. Under the umbrella of each of these plans, many different levels are provided as a result of local collective bargaining. For example, the health benefits fund provides coverage to several funding vehicles, to self-insurance, eight Blue Cross plans, one commercial insurance company, and one HMO. Also prescription drugs and vision claims are processed by a third party administrator with specific expertise in these types of benefits. The pension fund provides normal benefits ranging from $100 a month to $1,200 a month, at age 65 after 25 years of service. The average is at the $600 level.

Local unions may bargain for benefits to provide for early retirement without actuarial reduction, for protection in case there is a permanent reduction in force, for vesting at a rate greater than required by law and for benefits for years of service in excess of 25. The plans provide complete portability of benefits. For example, if a worker leaves one employer and moves to another employer who contributes to the plan either in the same geographical area or in a different part of the country, the worker's benefits rights are fully protected. It is as if a worker had been working for the same company all along—something Congress just mandated in the deficit reduction act for rank-and-file workers for former Bell system company employees.

Our appearance here today results from a desire to demonstrate to you how successful our plans have been. Very often one hears only about the failures and the problems of benefit plans. Our appearance results also from a concern that forthcoming legislation to be considered by your committee may hurt the successful plans that we feel are in the majority.

We are concerned that in an attempt to cure some of the failures or excesses that may exist, this legislation could damage many effective private benefit plans. Our appearance is also to disspell some of the misinformation that one often hears about benefits provided through the private sector. We would like to demonstrate that our benefit plans have successfully overcome what are often viewed as general problems. For example, it is often said that the tax advantages given employers to provide benefits principally aid the higher paid. We have heard it said that women do not benefit from the private sector system as presently constructed. Certainly, we have all heard that private benefits cannot and do not adjust for inflation. We would like to demonstrate that with the necessary tax advantages that employee benefits achieve and provided through collective bargaining are essential to the economic security of the workers, the dependents, and retirees who are covered by our plans. The health benefits fund covers bakery and confectionery workers in all classifications covered by collectively bargained plans. The employees are 30 percent women. Seventy-eight percent of the group is married and have their families covered with benefits. A local union may bargain for any of the 180 base plans in combination with life insurance benefits from one to 20,000. Four optional dental plans. Two optional vision plans. One optional drug plan.

Contribution rates from 44 cents an hour to $2.39 per hour. In our health plans during the fiscal year ending on May 31——

Senator PACKWOOD. I am going to have you to conclude, Mr. DeConcini. I have got to stay on time or we will never finish the rest of our witnesses.

Mr. DECONCINI. All right. I want to make this point in conclusion, Senator. The point that you made earlier in this testimony. The choice is that union members are needy, older people in our Nation who will join together to lobby, probably successfully, for basic security. Retirement and income health coverage paid for by the Government through increased social security and medicare and other medical benefits. This would do nothing in the long run to reduce the deficit or to improve the efficient delivery of health and retirement coverage. We urge you to continue encouraging the development and growth of plans such as ours which serve our members, young and old, men and women, at all income levels within our industry. Thank you very much.

Senator PACKWOOD. Thank you very much.

[Mr. DeConcini's and Mr. Houston's prepared statement follows:]

SUMMARY OF STATEMENT BY

JOHN DeCONCINI and JAMES HOUSTON

to

THE SENATE FINANCE COMMITTEE (SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT) HEARINGS ON FRINGE BENEFITS, JULY 1984

Health Benefit Fund covers 41,800 Members & families in 39 states.

Pension Fund covers 80,000 workers in 46 states.

1,709 Contributing Employers.

Health Benefits cover the normal range of benefits, i.e., Life Ins., Hospital Ins., Medical, Dental, Optical and Prescription Drug Benefits.

Pension Benefits range from $100 to $1,200 per month w/ an average of $600 per month.

All benefits are portable - coverage continues for employment by any and each of the employers.

Purpose of appearance - To testify to the fact that present Plans provide benefits to young and old, male and female, and to hourly workers from lower paid unskilled to higher paid skilled.

The system is designed to meet the needs of employees of the baking and confectionary industries.

The Funds provide for economic security that could not otherwise be provided.

If these benefits were discouraged, equivalent dollars would be spent through government programs and those programs would not meet the needs of the members as well as the benefits negotiated and bargained by the union and the employers.

The ability to bargain future contributions to benefit programs will be severely injured if providing fringe benefits becomes more expensive for an employer than providing wages. That will create strong pressure for the government to provide additional programs out of tax revenues.

JOHN DECONCINI
INTERNATIONAL PRESIDENT
BAKERY, CONFECTIONERY AND TOBACCO WORKERS
INTERNATIONAL UNION AFL-CIO; CHAIRMAN
OF THE BAKERY AND CONFECTIONERY UNION
AND INDUSTRY INTERNATIONAL HEALTH
BENEFITS AND PENSION PLANS

JAMES HOUSTON
VICE PRESIDENT
ITT CONTINENTAL BAKING COMPANY
SECRETARY OF THE BAKERY AND CONFECTIONERY
UNION AND INDUSTRY INTERNATIONAL HEALTH
BENEFITS AND PENSION PLANS

THE SENATE FINANCE COMMITTEE (SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT) HEARINGS ON FRINGE BENEFITS, JULY 1984

I AM JOHN DECONCINI, PRESIDENT OF THE BAKERY AND CONFECTIONERY AND TOBACCO WORKERS INTERNATIONAL UNION, AFL-CIO. SEATED NEXT TO ME IS JAMES HOUSTON, VICE PRESIDENT, ITT CONTINENTAL BAKING COMPANY. WE ARE, RESPECTIVELY, CHAIRMAN AND SECRETARY OF THE BAKERY AND CONFECTIONERY UNION AND INDUSTRY INTERNATIONAL HEALTH BENEFITS AND PENSION PLANS. WE VERY MUCH APPRECIATE THE OPPORTUNITY TO TESTIFY BEFORE THE SENATE FINANCE COMMITTEE (SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT) ON THE SUBJECT OF FRINGE BENEFITS.

THE BAKERY AND CONFECTIONERY UNION AND INDUSTRY INTERNATIONAL HEALTH BENEFITS PLAN COVERS 41,800 BAKERY AND CONFECTIONERY WORKERS AND THEIR FAMILIES IN 39 STATES IN THE UNITED STATES. THE BAKERY AND CONFECTIONERY UNION AND INDUSTRY PENSION PLAN COVERS 80,000 WORKERS IN 46 STATES.

THERE ARE 1,709 CONTRIBUTING EMPLOYERS TO ONE OR MORE OF THE PLANS RANGING IN SIZE FROM THE LARGEST BAKING COMPANIES TO SMALL 1 AND 2 PERSON RETAIL BAKERIES. UNDER THE UMBRELLA OF EACH OF THESE PLANS MANY DIFFERENT LEVELS ARE PROVIDED AS A RESULT OF LOCAL COLLECTIVE BARGAINING. FOR EXAMPLE, THE HEALTH BENEFITS FUND PROVIDES COVERAGE THROUGH SEVERAL FUNDING VEHICLES: THROUGH SELF-INSURANCE, THROUGH EIGHT BLUE CROSS PLANS, ONE COMMERCIAL INSURANCE COMPANY, AND ONE HMO. ALSO, PRESCRIPTION DRUG AND VISION CLAIMS ARE PROCESSED BY A THIRD-PARTY ADMINISTRATOR WITH SPECIFIC EXPERTISE IN THESE TYPES OF BENEFITS.

THE PENSION FUND PROVIDES NORMAL BENEFITS RANGING FROM $100 PER MONTH TO $1200 PER MONTH AT AGE 65 AFTER 25 YEARS OF SERVICE. (MOST WORKERS ARE COVERED AT THE $600 LEVEL.) LOCAL UNITS MAY BARGAIN FOR BENEFITS THAT PROVIDE FOR EARLIER RETIREMENT WITHOUT ACTUARIAL REDUCTION, FOR PROTECTION IN CASE THERE IS A PERMANENT REDUCTION IN FORCE, FOR VESTING AT A RATE GREATER THAN REQUIRED BY LAW AND FOR BENEFITS FOR YEARS OF SERVICE IN EXCESS OF 25.

THE PLANS PROVIDE COMPLETE PORTABILITY OF BENEFITS. FOR EXAMPLE, IF A WORKER LEAVES ONE EMPLOYER AND MOVES TO ANOTHER EMPLOYER WHO CONTRIBUTES TO THE PLAN EITHER IN THE SAME GEOGRAPHICAL AREA OR IN A DIFFERENT PART OF THE COUNTRY, THE WORKERS BENEFIT RIGHTS ARE FULLY PROTECTED. IT IS AS IF THE WORKER HAD BEEN WORKING FOR ONE

COMPANY ALL ALONG -- SOMETHING CONGRESS JUST MANDATED, IN THE DEFICIT REDUCTION ACT FOR RANK AND FILE WORKERS OF FORMER BELL SYSTEM COMPANIES.

OUR APPEARANCE HERE TODAY RESULTS FROM A DESIRE TO DEMONSTRATE TO YOU HOW SUCCESSFUL OUR PLANS HAVE BEEN. VERY OFTEN ONE HEARS ONLY ABOUT THE FAILURES AND THE PROBLEMS OF BENEFIT PLANS. OUR APPEARANCE RESULTS ALSO FROM A CONCERN THAT FORTHCOMING LEGISLATION TO BE CONSIDERED BY YOUR COMMITTEE MAY HURT THE SUCCESSFUL PLANS THAT WE FEEL ARE IN THE MAJORITY. WE ARE CONCERNED THAT IN AN ATTEMPT TO CURE SOME OF THE FAILURES OR EXCESSES THAT MAY EXIST, THIS LEGISLATION COULD DAMAGE MANY EFFECTIVE PRIVATE BENEFIT PLANS. OUR APPEARANCE IS ALSO TO DISPEL SOME OF THE MISINFORMATION THAT ONE OFTEN HEARS ABOUT BENEFITS PROVIDED THROUGH THE PRIVATE SECTOR. WE WOULD LIKE TO DEMONSTRATE THAT OUR BENEFIT PLANS HAVE SUCCESSFULLY OVERCOME WHAT ARE OFTEN VIEWED AS GENERAL PROBLEMS. FOR EXAMPLE, IT IS OFTEN SAID THAT THE TAX ADVANTAGES GIVEN EMPLOYERS TO PROVIDE BENEFITS, PRINCIPALLY AID THE HIGHLY PAID. WE HAVE HEARD IT SAID THAT WOMEN DO NOT BENEFIT FROM THE PRIVATE PENSION SYSTEM AS PRESENTLY CONSTRUCTED. CERTAINLY, WE ALL HAVE HEARD THAT PRIVATE BENEFITS CANNOT AND DO NOT ADJUST FOR INFLATION. WE WOULD LIKE TO DEMONSTRATE THAT WITH THE NECESSARY TAX ADVANTAGES EMPLOYEE BENEFITS ACHIEVED AND PROVIDED THROUGH COLLECTIVE BARGAINING ARE ESSENTIAL TO THE ECONOMIC SECURITY OF THE WORKERS, THEIR DEPENDENTS AND RETIREES WHO ARE COVERED BY OUR PLANS

THE BAKERY AND CONFECTIONERY UNION AND INDUSTRY INTERNATIONAL HEALTH BENEFITS FUND COVERS BAKERY AND CONFECTIONERY WORKERS IN ALL CLASSIFICATIONS COVERED BY COLLECTIVELY BARGAINED PLANS. OF THE EMPLOYEES, 30% ARE WOMEN. 78% OF THE GROUP IS MARRIED AND HAVE THEIR FAMILIES COVERED FOR BENEFITS. A LOCAL UNION MAY BARGAIN FOR ANY OF THE 180 BASE PLANS IN COMBINATION WITH LIFE INSURANCE BENEFITS FROM $1,000 TO $20,000, 4 OPTIONAL DENTAL PLANS, 2 OPTIONAL VISION PLANS AND 1 OPTIONAL DRUG PLAN. CONTRIBUTION RATES RANGE FROM 44¢ PER HOUR TO $2.39 PER HOUR.

DURING THE FISCAL YEAR ENDED MAY 31, 1984, 367,158 CLAIM CHECKS WERE ISSUED FOR 104.5 MILLION IN TOTAL BENEFITS. THE BAKERY AND CONFECTIONERY UNION AND INDUSTRY PENSION PLAN HAS, AS OF MAY 31, 1984, 30,417 PENSIONERS OF WHOM 19,657 WERE MEN AND 10,760 WERE WOMEN. BENEFIT PAYMENTS TO THESE RETIREES FOR THE FISCAL YEAR ENDED MAY 31, 1984, AMOUNTED TO $103,000,000. AS OF MAY 31, 1984, THERE WERE 77,900 ACTIVE MEMBERS, 34,400 OR 44% WERE FULLY VESTED IN THEIR BENEFITS. THERE ARE AN ADDITIONAL 16,000 EMPLOYEES WHO HAVE PREVIOUSLY WORKED IN THE INDUSTRY WHO HAVE NOT YET REACHED RETIREMENT AGE BUT WHO HAVE EARNED VESTED RIGHTS IN BENEFITS BASED ON THEIR WORK EXPERIENCE IN THE PAST AND WILL RECEIVE PENSIONS WHEN THEY REACH RETIREMENT AGE. THE PROBLEM OF ADJUSTING PENSIONS ALREADY IN PAYMENT STATUS FOR INFLATION HAS BEEN ADDRESSED BY A SERIES OF ADJUSTMENTS OVER THE PAST SEVERAL YEARS. THE MONEY TO

PAY FOR THESE INCREASES WAS EARNED THROUGH GREATER THAN EXPECTED INVESTMENT EARNINGS WHICH RESULTED FROM THE CAREFUL MANAGEMENT OF THE FUND'S BILLION DOLLAR INVESTMENT PROTFOLIO. THESE ADJUSTMENTS HAVE TAKEN VARIOUS FORMS. FOR EXAMPLE, ALL PENSIONERS RECEIVED A $25 MONTHLY INCREASE IN THEIR PENSION CHECKS BEGINNING DECEMBER 1, 1980. IN DECEMBER 1, 1982, ALL PENSIONERS NOT INCLUDED IN THE PREVIOUS INCREASE RECEIVED A $25 INCREASE IN THEIR BENEFIT. ON NOVEMBER 1, 1982, THERE WAS AN $8,601,000 PAYMENT TO PENSIONERS ON THE ROLLS AS OF THAT DATE. THIS WAS DISTRIBUTED ACCORDING TO A FORMULA PROVIDING AMOUNTS FROM $150 TO $300 DEPENDING ON HOW LONG A PENSIONER HAD BEEN ON THE ROLLS. THERE WILL BE ANOTHER SIMILAR PAYMENT IN THE AUTUMN OF 1984 FOR THOSE ON THE ROLLS. THE LUMP SUM AMOUNTS TO BE PAID IN THIS DISTRIBUTION VARY FROM $300 TO $400.

WE FEEL THAT OUR MEMBERS HAVE BEEN WELL SERVED BY THE PRIVATE BENEFIT SYSTEM AND THAT THE RESULTS ACHIEVED THROUGH COLLECTIVE BARGAINING AND THE DELIBERATIONS OF THE BOARD OF TRUSTEES HAVE RESULTED IN ECONOMIC SECURITY FOR OUR MEMBERS THAT COULD NOT OTHERWISE BE PROVIDED. THIS FORM OF SECURITY IS IMPORTANT TO US BECAUSE IF FITS OUR INDUSTRY AND THE RETIREES FROM OUR INDUSTRY. IF ACTION WERE TAKEN TO DIS-COURAGE PRIVATE BENEFITS, WE ALL KNOW THAT AT LEAST EQUIVALENT DOLLARS WOULD BE SPENT THROUGH GOVERNMENT PROGRAMS. WE HAVE GRAVE DOUBTS ABOUT WHETHER OR NOT THEY WOULD MEET THE NEEDS OF OUR MEMBERS AS WELL AS THE BENEFITS NEGOTIATED AND BARGAINED BY OUR MEMBERS' REPRESENTATIVES AND THEIR EMPLOYERS.

WE UNDERSTAND THAT IT IS THE INTENTION OF YOUR COMMITTEE, DURING THE NEXT SESSION OF CONGRESS, TO SHAPE THE WAY IN WHICH OUR NATION'S DEFICIT IS TO BE REDUCED. WE KNOW THAT THE AMOUNT OF CONTRIBUTIONS TO PRIVATE BENEFIT PLANS IS LARGE. THE FACT THAT THEY ARE TAX DEDUCTIBLE SEEMS ON FIRST GLANCE, TO INDICATE THAT THIS IS A FRUITFUL AREA WHERE TAX REVENUES CAN BE RAISED THROUGH REDUCTIONS OF TAX INCENTIVES OR THROUGH INCREASES IN TAXES. WE URGE YOU TO AGAIN LOOK CLOSELY AT THE LONG-TERM RETURN ON THESE TAX DOLLARS IN TERMS OF:

FUTURE FEDERAL PROGRAMS THAT WILL NOT BE NECESSARY;

THE INCREASED PRIVATE INVESTMENT CAPITAL THAT ASSISTS IN MAINTAINING A STRONG ECONOMY AND;

THE EFFICIENT WAY THAT PROGRAMS SUCH AS OURS NOW PROVIDE BENEFITS TO OUR MEMBERS.

THERE IS NO DOUBT THAT OUR ABILITY TO BARGAIN FUTURE CONTRIBUTIONS TO BENEFIT PROGRAMS WILL BE SEVERELY INJURED IF PROVIDING FRINGE BENEFITS BECOMES MORE EXPENSIVE FOR AN EMPLOYER THAN PROVIDING WAGES. EMPLOYEES WOULD NOT PERMIT WAGES TO BE REDUCED BY AN EQUIVALENT AMOUNT IN RETURN FOR BENEFITS. EMPLOYERS WOULD NOT INCREASE WAGE PACKAGES. THE CHOICE IS THAT UNION MEMBERS AND NEEDY, OLDER PEOPLE IN OUR NATION WOULD JOIN TOGETHER TO LOBBY (PROBABLY SUCCESSFULLY) FOR BASIC SECURITY -- RETIREMENT INCOME HEALTH COVERAGE --

FROM THE GOVERNMENT THROUGH INCREASED SOCIAL SECURITY AND MEDICARE AND OTHER MEDICAL BENEFITS. THIS WOULD DO NOTHING IN THE LONG-RUN TO REDUCE THE DEFICIT OR TO IMPROVE THE EFFICIENT DELIVERY OF HEALTH AND RETIREMENT COVERAGE. WE URGE YOU TO CONTINUE ENCOURAGING THE DEVELOPMENT AND GROWTH OF PLANS SUCH AS OURS WHICH SERVE OUR MEMBERS -- YOUNG AND OLD, MEN AND WOMEN, AT ALL INCOME LEVELS WITHIN OUR INDUSTRY.

THANK YOU.

Senator PACKWOOD. Steve, and to everybody else, you know if we are going to change the educational benefit expiration in this session, we are going to have to crack the House or we are just not going to go anyplace. If we got a bill from the House with that in it, my hunch is we would accept it. Bob fought and fought and fought for it in the conference, and you saw what happened—we could not hold it. We have to start there.

I have watched and listened with amazement as the President has his news conference, and I see Bob on the Sunday morning programs frequently talking about the tax situation next year, and the definition of what a tax is. Apparently, if it is anything but an income tax, it may not be a tax, in which case it is acceptable. An excise tax is not a tax. And a user fee is not a tax. Only an income tax is a tax. I don't know if that means that the President is prepared to say, well, if we need revenue increases that aren't taxes, I will go along with them.

When we get into that battle, this whole area of employee benefits is going to be one part of a major revenue fight. What bothers me is that philosophy that I really think emanates more from the bowels of the Treasury Department and career people on the Joint Committee than it does any place else. That philosophy is that the tax code is really not to be used for anything but the raising of revenue. It is to be neutral on everything else, and if you follow that to its ultimate conclusion, of course, it goes beyond fringe benefits. It is dependency exemptions. Why should somebody who has children get a benefit over somebody who doesn't have children? It is the home mortgage interest deduction. I don't know of anybody who is talking about moving toward that kind of a tax code. But if we are, then everyone ought to understand what the other side of that will be. If we are going to try to encourage things beyond the marketplace and we are not going to use the tax code, whether it is untaxed employee benefits or whether it is tax deductions, then the alternative is a Government program. If instead of the mortgage interest deduction, we are going to encourage housing, I guess the alternative is to apply for a grant from the local HUD office. When you find a house you want to buy, they will ask you how many rooms it has and how old the plumbing is and how long ago the lawn was put in, and you turn in your grant form. It comes back, 4 or 5 weeks later, or 4 or 5 months later, approved or disapproved. By that time, the house has been sold to somebody else, I am sure. That is the alternative to using the tax code for incentives. There are a few people philosophically consistent who believe in having it be absolutely neutral, and the marketplace will take care of everything—for better or for worse. I do not find that philosophy shared by very many people. That will animate and drive a good portion of the philosophy of the tax bill next year, and it is something to watch out for when we are talking about employee benefits.

I do wish you good luck on the House side on education this year. Of all of the benefits, that is one that is skewed more toward the lower income and the most needy and the ones for whom the benefit can do the most good, more than any other single fringe benefit.

Mr. KOPLAN. Mr. Chairman, No. 1, I would like to say that I share your view as to where we need to concentrate our efforts. Obviously, the Senate did try to take care of this problem for us in the tax bill that you brought out of this committee. This particular fringe benefit—letting it die the way it did—was particularly cruel because many, many employees—I think with the exception of the University of Michigan—everybody assumed that this thing would be kept alive. Now, the result is that employees and employers retroactively to January owe FICA, owe FUTA, employees owe withholding—retroactively. This could be applying to people who don't even have jobs and they are going to have to come up now with retroactive moneys to January. So, the fact that this was allowed to die in the fashion that it did is a particular hardship on people which you have appropriately characterized as people who can't afford it. I don't know where they are going to come up with that money. Something has got to be done at least about that situation this year. I am not directing that to either you or Chairman Dole because you worked very closely with us on this one, but something does have to be done, and all of us at this table feel very, very strongly about that. I thank you for your comments.

Senator PACKWOOD. Bob?

Senator DOLE. I would just reiterate what I said earlier. You know what happens once you get a tax bill on the floor.

Mr. KOPLAN. Sure.

Senator DOLE. There are 5,000 people who have various amendments, and we couldn't go through that now. We could package a little deal.

Mr. KOPLAN. We would be glad to revisit the question of withholding on interest and dividends. Perhaps we should work something out with you on that one. [Laughter.]

Senator DOLE. I guess my banker is just now speaking to me again. [Laughter.]

We will try to work out something, but I hope you understand the difficulty of that, on the House side.

Mr. KOPLAN. Sure.

Senator DOLE. I would just like to ask a general question. Is organized labor supportive of these flat tax, fair tax, mass tax proposals? I don't know what they do to all these fringe benefits, but I don't think they do them too much good. Are you on record in favor of any of those?

Mr. KOPLAN. We are on record opposed to the flat tax.

Senator DOLE. There is the flat, the fair, the first, and so on.

Mr. KOPLAN. There are various versions. There is one version—I believe it is characterized as the fair tax by those that introduced it—that is more progressive. It would depend on, you know, we would have to look at that as an option to consider, but the pure flat tax is something that we do oppose because it would do away with all of this.

Senator DOLE. We are going to have some hearings on this on the 7th and the 9th of August. I am not abdicating any of those.

Mr. KOPLAN. Sure. We will be appearing.

Senator DOLE. We are just going to take a look at some of the options, in the event they are needed. I mean, if Mondale should be elected, we have got to be ready to raise taxes. [Laughter.]

Senator PACKWOOD. Bob raises a valid point on the flat tax, and he phrases it correctly. You have got to ask somebody what is meant by a flat tax. Bradley-Gephardt calls it a flat tax, and it is a progressive flat tax which is an internal contradiction in terms. If you really mean flat tax, no exemptions and no deductions, my calculations are, as a rule of thumb, everyone who makes over $30,000 a year will pay less tax, and everybody who makes under $30,000 a year will pay more tax. Now, there will be some exceptions to that, but by and large, that is where it will come out.

Mr. KOPLAN. That is right, and that is why our preferenc is to deal with individual sections of the tax code and individual reforms as opposed to simply flat tax.

Senator PACKWOOD. Folks, thank you very much.

Mr. KOPLAN. Thank you.

Senator PACKWOOD. Next, we will take Robert Winters, who is the executive vice president of Prudential Insurance, Hayden Hankins, the director of the Halliburton Co., Peter Biggins of LTV, and Roy Howard, the assistant vice president for BellSouth.

Mr. Winters, do you want to go first?

STATEMENT OF ROBERT C. WINTERS, EXECUTIVE VICE PRESIDENT, PRUDENTIAL INSURANCE CO. OF AMERICA, WASHINGTON, DC

Mr. WINTERS. Thank you, Senator. My name is Robert Winters. I am an executive vice president at The Prudential Insurance Co. of America. Although our business is insurance, we are testifying today as an employer, whose benefit plans cover more than 220,000 employees and their dependents.

The system of employee benefits in this country has been effective in providing for the economic security of American workers and their families. This system, consisting of a floor of mandated benefits, plus tax incentives and fairness standards, successfully provides basic financial security to broad segments of our population. This security serves individuals, through protection against personal financial catastrophy, and society, by reducing the burden on public welfare. We are concerned, however, as other witnesses have expressed also, that frequent, piecemeal revenue-driven legislation has the potential for seriously undermining the success of the current system. What is needed, as Mr. Dole expressed in his remarks, is a national policy on employee benefits, with a clear statement of objectives. Once the objectives have been defined, the Congress will be in a better position to decide whether proposed changes further the national policy.

The present system of employee benefit taxation may be viewed as an informal partnership among Government, employers, and employees. We believe that this partnership is the most effective way of providing benefits to American workers because it recognizes several important characteristics of our society. First, as you have expressed, the Government cannot provide needed protection to employees against all significant economic risks. Second, many American workers could not or would not on their own protect themselves from the risks of catastrophic illness, early death, or disability. Third, the competitive free enterprise system is an efficient means of allocating resources. And fourth, employers are in the best position to minimize the cost of benefits and to maximize their effectiveness to employees.

Prudential's qualified thrift savings plan offers an excellent example of the system working well. Our plan provides for a basic contribution of 3 percent of pay by the employee. Prudential matches that contribution dollar for dollar. An employee may make additional unmatched contributions of up to 10 percent of pay. The money accumulates on a tax-deferred basis in investment funds of the employee's choice. This plan is easily the most popular of our employee benefits. At the lowest income levels, three-quarters of the eligible employees participate. Overall the participation rate is 85 percent. Moreover, employees at all pay levels make substantial additional deposits. The average contribution rate is 7 percent, as compared with the 3 percent minimum required, for those of our employees who earn less than $15,000, and 9.1 percent for our top income group. This range of only 2 percent of contributions we find remarkable. Interestingly, the proportion of employees making the maximum contribution of 13 percent of pay is quite large at all income levels—about one-third—27 percent for our very lowest income group.

Mr. Chairman, I suggest that this voluntary behavior of our employees demonstrates the power of tax incentives in motivating the provision of basic financial protection for American workers and in energizing capital formation in our economy. We hope that these hearings and the work which follows them will lead to the development of a thoughtful national policy on employee benefits. And we look forward to participating in the development of such a policy. And I thank you for the opportunity to appear.

Senator PACKWOOD. Thank you. Mr. Hankins?

[Mr. Winters' prepared statement follows:]

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

UNITED STATES SENATE

HEARINGS ON FRINGE BENEFITS

STATEMENT OF

THE PRUDENTIAL INSURANCE COMPANY OF AMERICA

JULY 26, 1984

The following statement is submitted by The Prudential Insurance Company of America for inclusion in the record of the hearings on fringe benefits held by the Subcomittee on Taxation and Debt Management on July 26, 27 and 30, 1984. This statement sets forth the views of The Prudential regarding the issues raised by the Subcommittee in its press release dated June 4, 1984.

Prudential, the largest life insurance company in the United States, provides pension, welfare and other benefits to nearly 75,000 Prudential employees and agents working in all 50 states. The Prudential also funds and/or administers pension and welfare benefit programs covering tens of millions of employees of private employers across the country.

Our primary views in this area may be briefly summarized as follows:

I. The current system of employee benefit taxation is working well and should be continued.

II. The current system should be simplified and improved through the provision of uniform nondiscrimination rules for all statutory employee benefits, the encouragement of cafeteria plans and in other ways.

III. If broad reconsideration is to be given to the tax treatment of employee benefits, it is essential that -- before any decisions on the tax treatment of particular benefits are made -- we first develop a national policy on employee benefits.

I. THE CURRENT SYSTEM OF EMPLOYEE BENEFIT TAXATION IS WORKING WELL AND SHOULD BE CONTINUED

We believe that the existing tax system -- under which employers are encouraged to fill important needs for individual economic security and to supplement Governmental programs such as Social Security and Medicare -- is a good one and should be continued without substantial change. We think that the current system is the most effective approach possible to providing needed benefits to a broad cross-section of American workers. The present structure has fostered a very efficient informal partnership between Government, employers, and employees that should not be altered lightly.

Our views in this area reflect a variety of important considerations.

First, the current structure recognizes that the Government is not in a position to provide needed protection to employees against all significant economic risks. Indeed, the problems experienced by the Social

Security system during the past decade, as well as the problems projected for Medicare, illustrate the difficulties created when the Government assumes the primary burden.

Second, the current structure recognizes that many American workers would not or could not provide on their own for the potential financial strains of retirement, catastrophic illness, early death or disability.

Third, the current structure recognizes that employers are in the best position to contain benefit costs and maximize their effectiveness to employees.

Finally, the current structure takes advantage of the competitive nature of the free enterprise system.

1. The Current Tax System Promotes Important Social and Economic Policies

While the primary purpose of the Internal Revenue Code is to raise revenue for the Federal Government, it is also designed to encourage many socially desirable actions in furtherance of a commitment to certain national objectives. For example, because a majority of women today find it necessary or desirable to work, the law encourages dependent care; in order to promote fuel conservation and reduce pollution, favorable tax treatment is afforded for van pool arrangements; and, as part

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of a fundamental concern for individual income security, well-established employee benefits, including retirement, health, disability and death benefits, have been encouraged with tax incentives.

The tax law also is an important instrument that promotes national economic policy. For example, the tax law encourages the creation of qualified retirement plans and thrift savings programs not only to provide for individual income security, but also to generate substantial amounts of long-term investment capital for the economy.

2. Employer-Sponsor Programs, Maintained Within Broad Tax and Legal Policy Frameworks, Provide Benefits Most Efficiently

The current system recognizes that employers are uniquely situated to minimize the cost of benefits and maximize the effectiveness of benefits provided to employees.

Employers, often in formal or informal consultation with their employees, are in the best position to identify and evaluate benefit choices based on the needs of their particular work force, geographic location and industry. One major reason for the success of the current system is that it is flexible in accommodating the varying needs of different American workers.

Employers have the incentive and the resources necessary to deliver the best benefits at the lowest possible cost to their employees. Employee benefit expenses represent a cost of doing business that any well-run business will seek to make cost effective.

Insurers, organizations such as Blue Cross/Blue Shield and alternative health care delivery systems actively compete to obtain the employee benefit business of employers. Employers are usually in a better position than their employees to evaluate the large volume of complex and sometimes conflicting information that affects their employee benefit plans and objectives. Also, many employers have the purchasing power to provide more comprehensive and cost effective benefits than individuals could purchase on their own with the same dollars. Moreover, many employers benefit from the economies of scale inherent in the purchase of benefits for a large work force.

The Prudential's experience confirms our belief that employers can provide needed benefits to their workers at the lowest overall cost. For example, during 1983, it cost The Prudential approximately $1,900 per employee for health benefits. Health coverage of equivalent value, for which we charge an employee who is married and has one or more children only $4.70 a week ($244 per year), simply cannot be purchased by an individual on the open market. If it could be replaced, however, the cost of replacing it would be substantially greater than the current cost of the coverage.

A similar story can be told in the pension area. The Prudential pays the entire cost of the retirement plan for its employees. For a 30-year-old employee, currently earning $31,400 per year, to provide a retirement income of $27,400 per year beginning at age 65, it would cost 9.4 percent of gross pay each year for 35 years.*/ That would represent $2,965 -- or nearly 10 percent of gross pay -- in the first year alone, which is far more than many employees can reasonably afford, particularly at younger ages.

3. Employer-Sponsored Programs, Administered Within the Constraints of the Tax Laws, Provide Benefits Fairly to a Broad Cross-Section of Employees at All Compensation Levels

Current law assures that benefits will be provided to a broad cross-section of employees at all compensation levels. The tax rules prohibit discrimination in

*/ In setting this retirement income target, we have assumed a modest increase in the employee's salary each year between now and retirement.

favor of officers, shareholders and highly compensated employees, and are effective in preventing such discrimination.

The Prudential's experience with its benefit plans is consistent with the view that benefit plans often favor lower-paid individuals. Even though our health insurance plan is contributory, a full 98 percent of our work force has elected to be covered. If our employees were forced to purchase these benefits in the individual market, they would be required to pay considerably more than the present cost of the coverage, and the benefits provided would result in significant gaps in protections; lower-paid individuals would suffer disproportionately. Similarly, if employer contributions for these benefits were taxed to employees, lower-paid individuals would again suffer disproportionately.

Similarly, our qualified thrift savings plan enjoys extremely broad participation by our work force. That plan requires that the employee contribute 3 percent of salary in order to participate. The Company matches 100 percent of that employee contribution. In addition, employees may contribute up to an additional 10 percent of pay to the plan. At the present time, 85 percent of our eligible employees are participating in the plan. Perhaps more significant is the fact that contribution rates are approximately the same at all compensation levels. A full one-third of our employees at all compensation levels contribute 3 percent of their compensation to our thrift savings plan. Another one-third contribute 13 percent of their compensation. The remaining employees, at all compensation levels, save between 4 and 12 percent of compensation in our thrift savings plan. The average employee, at all compensation levels, saves between 7 and 9 percent of compensation. These participation rates for our thrift savings plan are illustrated in Appendix A and Appendix B respectively.

This experience demonstrates that the current tax system does work to achieve the intended social and economic objectives. Lower-paid employees receive the same health benefits as higher-paid employees. Employees at all income levels are encouraged to and do save for retirement and other purposes. The monies used to fund for these purposes provide necessary long-term investment capital. The net result is that the system both provides financial security to employees and encourages significant capital formation to support industrial development in the United States.

4. Ultimately, There Is No "Free Lunch" for the Government, for Employers, or for Employees

Any tax incentives to encourage the provision of employee benefits by employers will cost the Treasury a certain amount of revenue. While it is clearly appropriate for the Congress to analyze the revenue impact of any tax incentive in light of the effectiveness of the incentive and other factors, we think that revenue cost should not be given undue weight. The Congress should recognize that the major cost of providing benefits is being paid by employers and employees, even though the Government does bear part of the cost through tax incentives.

An employer must commit at least 54 cents for every dollar expended on benefits. The Government contributes no more than 46 cents of that dollar. An employee must include the value of many benefits in income currently or at some date in the future. The employee who is required to pay for part of his benefits often must do so out of after-tax income. Even when the employee can pay for his benefits on a pre-tax basis, he must commit at least 50 cents for every dollar expended. The Government usually contributes much less than 50 cents for each dollar spent by an employee for employee benefits.

There is no "free lunch" for employers, employees or the Government under the current system. Alternative systems for providing comparable benefits, however, would likely cost at least as much, or more, in the aggregate. A major difference between alternative approaches and the current system is that the costs will be allocated between the Government, employers and employees differently. Moreover, experience teaches that the costs would be higher and/or the protection lower.

II. THE CURRENT SYSTEM OF EMPLOYEE BENEFIT TAXATION NEEDS TO BE REFINED TO SIMPLIFY THE LAW, PRESERVE THE REVENUE BASE AND SLOW THE ESCALATION OF BENEFIT COSTS

We recognize that even a good system can, indeed should, be improved. The law should better balance the need for fairness with the need for administrative simplicity. Moreover, the law should provide more objective standards that will permit both the Internal Revenue Service and employers to stay off the litigation merry-go-round as much as possible. To the extent that the law does not meet these objectives, employers will be driven to provide benefits to key employees through nonqualified plans. These plans may result in less initial revenue loss than under qualified plans, but they will not benefit most workers. However, to the extent that the law does meet the objective of administrative simplicity, both employers and the IRS can concentrate on their primary purposes more effectively.

1. <u>The Law Should Be Simplified, Consistent With the Public Policy Objectives</u>

The Prudential would support appropriate amendments to the tax law to provide uniform nondiscrimination rules for all statutory fringe benefits and cafeteria plans. Current law contains many inconsistencies that should be removed to simplify the statute and make it easier for employers to administer their benefit plans. For example, the tax law contains at least seven different definitions of the "prohibited group" (officers, shareholders, highly compensated employees, etc.) for discrimination purposes under seven different types of benefit plans. Those seven different definitions contain sixteen different categories of persons who must not be favored relative to other employees. Those categories are set forth in Appendix C.

In addition to the existence of different categories of individuals who may be part of the "prohibited group," only five of those sixteen categories are contained in more than one definition. Of those five categories, three categories are used in two definitions each. Two of those categories are used in four different definitions. The lack of consistency among these definitions is illustrated in Appendix D.

There is no apparent reason for these complex and inconsistent definitions. They do not appear to promote any identifiable public policy. Nevertheless, they severely hamper the administration of benefit plans by employers. Moreover, they make it difficult to administer a cafeteria plan containing several benefits which are subject to different nondiscrimination rules.

2. The Law Should Include More Objective Standards so that Employers Have Firm Guideposts on Which They Can Rely

The tax laws contain many vague standards that are not susceptible of accurate definition and measurement. Frequently, these "facts and circumstances" tests are appropriate since they give needed flexibility to the law. Nevertheless, such tests should not be the only test applicable to a particular employee benefit. It is extremely important that an employer be able to design a plan that clearly complies with the law. As the law stands today, however, an employer is frequently subject to being second-guessed by an IRS audit agent. That fact can weigh heavily in a decision by an employer regarding whether it will make a benefit available to its employees.

We believe that, wherever it is possible, "facts and circumstances" tests should be supplemented by "safe harbor" rules that draw "bright lines" for employers. Those employers who are risk-averse will be encouraged to provide benefits using such rules whereas they might not otherwise provide the benefit. An example of a case in which a safe harbor rule has worked well can be found in Code section 401(k) relating to cash or deferred profit-sharing plans.

A "safe harbor" test will facilitate determinations by both IRS and employers as to whether a plan is non-discriminatory. This means that the IRS will be able to preserve its energy for more productive, revenue-raising activity. Moreover, it will lessen the adversarial nature of the tax system and reduce the litigation expense currently being borne by both the Government and employers.

A good example of a provision in the law that needs a "safe harbor" rule is the term "highly compensated employee." That term is so subjective and so vague that it can represent a significant impediment to the implementation by an employer of benefit plans. In many cases, an employer will not know whether its plan is nondiscriminatory for many years, long after it has made its contributions for one or more plan years. In fact, this uncertainty was one of several factors that led The Prudential to defer the implementation of a cafeteria plan.

3. Serious Consideration Should Be Given to Consolidating or Better Coordinating Employee Benefit Policy and Regulation

Under present law, at least four Federal agencies or commissions -- Treasury/IRS, the Department of Labor, the Pension Benefit Guaranty Corporation and the Equal Employment Opportunity Commission -- have responsibility for interpreting and enforcing the major laws relating to employee benefit plans. In many cases, this fragmented decision-making process has delayed the resolution of important issues or resulted in conflicting interpretations of the laws. For example, in 1983, the IRS and PBGC proposed to adopt directly conflicting positions on the question of whether interest should be payable when certain mistaken payments are refunded to employers by employee benefit plans. Most recently, the EEOC decided to publish proposed interpretations of the Age Discrimination in Employment Act which, if adopted, would have the effect of imposing requirements on plans that were not intended under ERISA and the Code. Also, the IRS, the PBGC, and the Labor Department recently experienced initial difficulty in developing regulatory solutions to very important issues relating to the termination of defined benefit plans, and a uniform approach was not developed until guidance was provided by the Administration.

The occurrence of regulatory stalemates or conflicts such as those mentioned above periodically results from the natural inclination of each agency to interpret the law in the manner which is most consistent with its regulatory goals and according to its perceptions of the "right" policy or result, but without always giving full consideration to how its proposed resolution of the issue may affect the resolution of similar or related issues pending before other agencies. Such developments, however, have a variety of serious adverse effects on the employee benefit system including the imposition of unnecessary compliance costs and burdens on the private sector, and the creation of substantial uncertainty as to what the law actually requires -- to the detriment of employers, employees and the Government.

Ultimately, we believe that employers, workers and the Government would derive substantial benefits from successful efforts to consolidate the administration of the laws relating primarily to employee benefit plans, or at least to provide an effective mechanism for identifying issues that affect matters within the jurisdiction of two or more agencies and for resolving the issues in expeditious and uniform manner. Such efforts also could help provide a useful and necessary framework for developing a comprehensive national policy on welfare and retirement benefits.

4. Cafeteria Plans Should Be Encouraged In Order to Help Preserve the Revenue Base and Slow the Escalation of Benefit Costs

As noted previously, we believe that the current system of providing employee benefits works well and should be preserved. However, we also recognize the potential for fringe benefits to unduly erode the revenue base, and we are concerned about recent patterns of substantial escalation in benefit costs. In our view, properly designed cafeteria plans can effectively address these concerns as well as improve the ability of employers to provide needed benefits to employees in a more efficient and cost-effective manner.

Cafeteria plans are a natural outgrowth of an increasingly complex society under which individual needs vary more widely than was previously the case. The growing predominance of the two wage-earner family, the increasing number of one-person households and other demographic trends have all contributed to an employee population that has become quite heterogeneous in nature. In this context, cafeteria plans have already played, and should continue to play, a major role by allowing employees to become partners with their employers in the overall design of their employee benefit packages, thereby assisting their employers in efforts to control escalating benefit costs and to spend available benefit dollars more wisely. For example, in our experience, employees who have a choice tend to select medical or other benefits containing relatively high deductible or co-payment requirements if they can receive cash or other needed benefits in exchange. Moreover, when employees must pay for some of their medical expenses, they are less inclined to purchase marginally useful medical services and tend to shop more wisely for the services they need. Thus, cafeteria plans have the strong potential for containing benefit costs in ways that can both help the private sector control costs and help the public sector preserve the revenue base.

In view of the foregoing, we think that recent legislation which permits only cash and nontaxable benefits to be offered under cafeteria plans reflects a step in the wrong direction. We see no reason why employees should be precluded from selecting lower cost group automobile or group homeowner insurance coverage or other taxable benefits that can be readily valued under cafeteria plans. The availability of such choices, in addition to nontaxable benefits, can only encourage greater employee participation, lower benefit costs and produce more revenue.

The development of cafeteria plans has been substantially impeded by significant uncertainty over the specific rules that apply. In this regard, while some employers have established cafeteria plans, many others (including Prudential) have not done so because of the confused regulatory climate and their inability to obtain relatively firm assurance that they can satisfy the applicable tax law requirements. We note also that, while the recently proposed Treasury regulations resolve some important issues, they also raise some new issues and leave some basic issues unresolved. We are hopeful that, through the regulatory process, all of the major hurdles to the establishment and maintenance of sound cafeteria plans will be removed. Given a fair chance to operate under a reasonable and clear regulatory framework, there is good reason to believe that cafeteria plans will prove to be a major force in the containment of benefit costs to the advantage of employers, employees and the Government.

III. ANY RECONSIDERATION OF THE TAX TREATMENT OF EMPLOYEE BENEFITS SHOULD BE PRECEDED BY THE DEVELOPMENT OF CLEARLY ARTICULATED PUBLIC POLICY OBJECTIVES

1. The Need for a National Policy Regarding Employee Benefits

If any major changes in the tax treatment of fringe benefits are to be considered, it is critical that the Congress first articulate a national public policy on employee benefits and the objectives of that policy. Only after there is a precise understanding of where we are going, and why, can we improve the current system by measuring whether the tax treatment of particular benefits is consistent with the articulated policy. Stated differently, the creation of an appropriate tax policy framework should facilitate sound decisions on the proper tax treatment of employee benefits.

We are concerned that the last 10 years (and particularly the last few major tax packages) have marked a major departure from the period of relative tax law stability with respect to fringe benefits that existed until the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"). Indeed, the ten years following ERISA have been characterized by an incredible volume of complex tax and labor legislation affecting employee benefits that can be grouped in one of the following categories:

(1) legislation which liberalizes the treatment of existing employee benefits;

(2) legislation which establishes new tax-favored employee benefits; or

(3) legislation which restricts or further regulates various types of existing employee benefits.

Perhaps the only clear trend that has emerged from this flood of employee benefits legislation is that time and other practical constraints frequently do not permit adequate consideration of the merits of the proposals themselves; whether alternative proposals would be more effective or more simple; the potential impact of the proposals on future, as well as on current, benefit practices; or the collateral implications or effects of proposals intended to apply only to one particular benefit. This trend has very serious implications for the overall stability of employee benefit plans; the willingness of employers to continue existing plans or adopt new plans; complexity in the tax law; efforts to control and preserve the income tax base; and, ultimately, the overall economy in general.

The recent experience with constantly changing employee benefit legislation is indicative of the absence of an articulated policy on the treatment of employee benefits generally. It also demonstrates the need for serious efforts to develop a comprehensive tax policy framework for decision-making with respect to the tax treatment of employee benefits. The development of clearly articulated policy criteria governing fringe benefits should serve to promote needed stability in employee benefit plans and to establish the proper mix of social and tax policy goals that is necessary to provide better control over the revenue base. Ultimately, a properly designed policy framework should result in substantial long-term benefits to workers, employers and the Government itself.

2. The Current System For Providing and Taxing Employee Benefits Should Be Retained And Improved Under Any Tax System Ultimately Adopted

The need to control budget deficits, general dissatisfaction over the substantial complexity of the tax system and many other factors have prompted the Administration and many members of Congress to begin to develop recommendations for potentially restructuring the Federal tax system. In addition to Administration-initiated studies of such proposals, section 1081 of the Tax Reform Act of 1984 calls for a Treasury Department study of "alternative tax systems", including a simplified gross income tax, a consumption-based tax, value added or other national sales taxes, and measures that combine "income tax base broadening" with lower overall tax rates. Consideration of any significant "alternative tax system" will necessarily require consideration of the tax treatment of various forms of employer-provided benefits.

We believe that any broad reexamination of employee benefits should begin with the development of a clearly articulated tax policy governing the treatment of all employee benefits. In our view, that overall policy should have ~~two~~ underlying elements: (1) to preserve the basic system of providing employers with tax incentives to adopt and maintain benefit programs which achieve the defined social and economic policy goals, and (2) to ensure that the system accomplishes these objectives in an effective manner through reasonable and clear nondiscrimination standards which continue to require broad-based coverage of workers (as a prerequisite to the provision of the tax incentives) and also facilitate compliance and certainty by employers.

U.S. social and economic policy to date has been firmly grounded in the notion that it is important to provide economic security (and protection against common and significant financial risks) to workers and retirees. The Social Security system and ERISA reflect the commitment to retirement income security, and the judgment that this objective can best be accomplished by providing a floor of Governmental protection, supplemented by private industry efforts. Employer-provided health benefits and Medicare reflect a similar joint commitment. Both systems implicitly recognize that the Government cannot afford to be the sole provider of economic protection; indeed, we believe that the Federal Government's role in these areas may, by necessity, diminish in future years. Both systems also implicitly recognize that there is no assurance that workers, particularly lower and middle income workers, would independently provide themselves with these and other basic forms of protection.

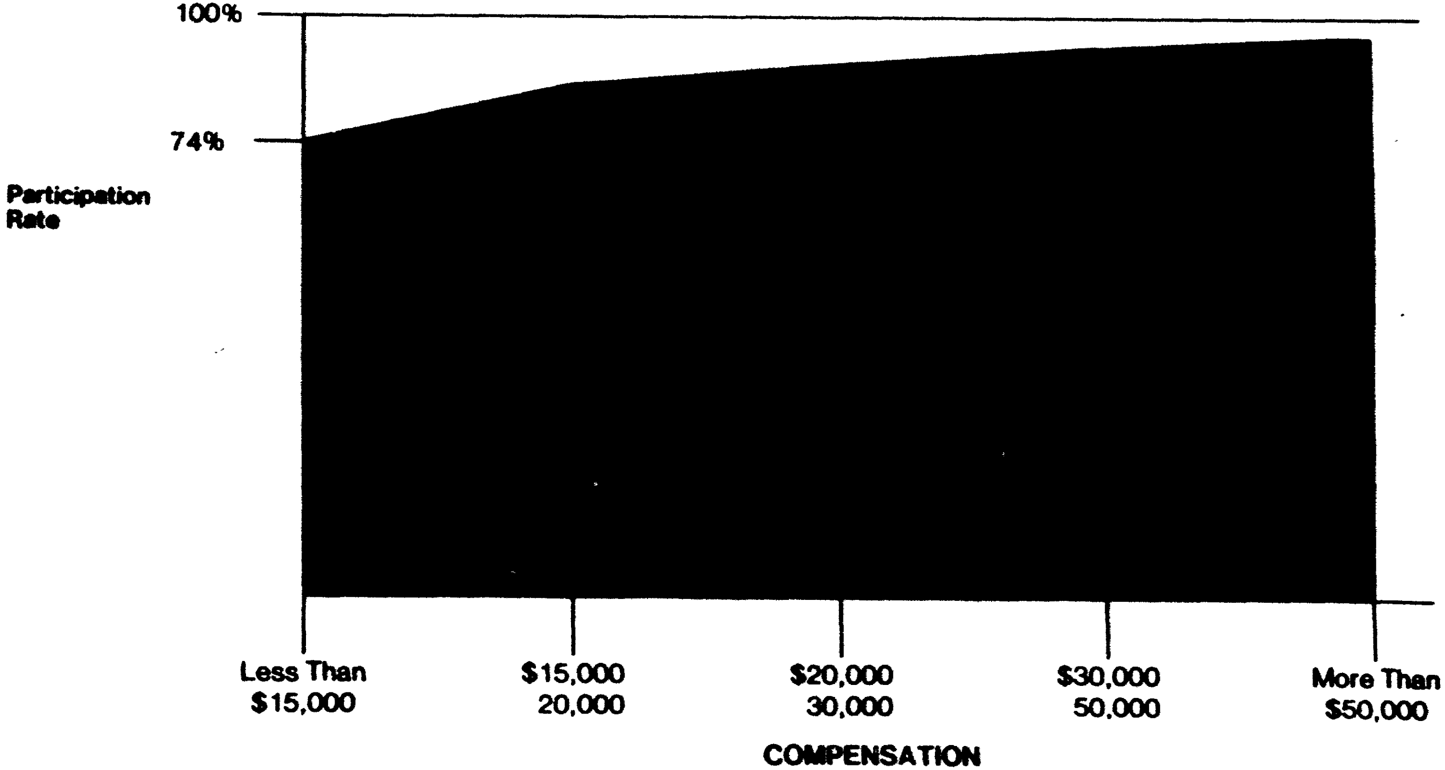
We believe that any consideration of alternative tax systems in general, and employee benefits in particular, will reach the conclusion that U.S. social and economic policy continues to view the voluntary provision of retirement, health, death, disability and other employee benefits as highly important to the public interest in worker security. Once this conclusion is reached, it follows that the current tax treatment of employee benefits should be preserved. In this regard, there is a substantial likelihood that, under any restructured tax system, there will be certain critical areas (such as home ownership and the treatment of charitable organizations) where the interest in conceptual consistency with the overall tax system will need to give way to the interest in preserving other highly important social and economic policy goals. In our view, to the extent that conceptual consistency may otherwise call for major changes in the current tax scheme, employee benefits should be one of those critical areas.

* * * * *

In closing, we would emphasize again that it is important to avoid making piecemeal decisions about employee benefits generally, and that the serious social and economic implications of any alternatives to the current system must be given the most careful consideration. The current system is not perfect. It should be preserved, however, since it has proven to be an effective way of delivering -- with little direct Government involvement -- needed benefits to tens of millions of American workers and retirees.

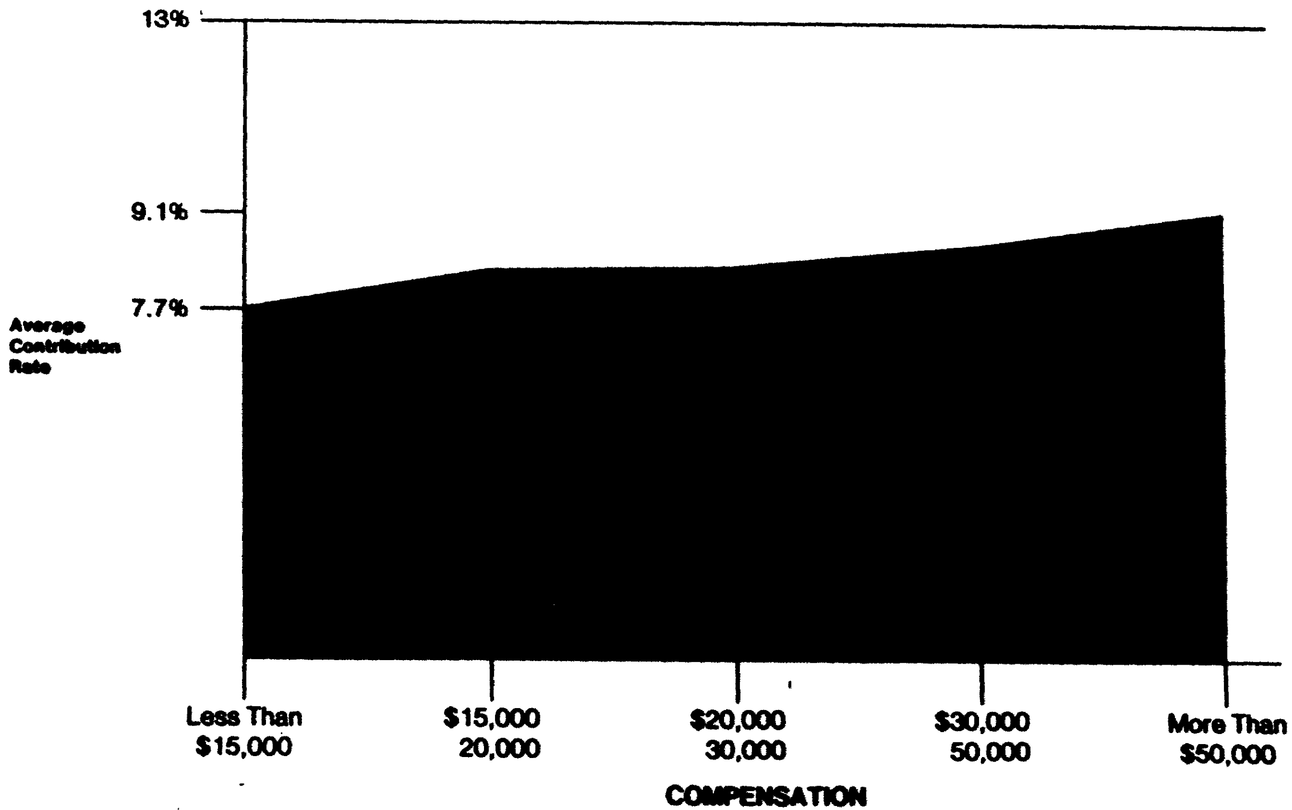
PRUDENTIAL THRIFT SAVINGS PLAN

Participation as a Function of Compensation



PRUDENTIAL THRIFT SAVINGS PLAN

Average Employee Contribution Rate
at various Levels of Compensation



DEFINITION OF KEY EMPLOYEE

Appendix C

Category	Code Section	No. of Plans Applicable To	Key to Appendix D
1. Owners	129	1	
2. 1% Owners Earning $150,000 Unless Excluded	79	1	
3. 5% Owners	79	1	
4. Top 10 Employee Owners	79	1	
5. Shareholders	401(a), 120	2	
6. 5% Shareholders	125	1	
7. 10% Shareholders	105(h), 505	2	
8. Self-Employed Persons	120	1	
9. Officers	401(a), 120, 125, 129	4	
10. Officers ≥ 3 Earning $> \$45,000$ ≤ 50	79	1	
11. 5 Highest Paid Officers	105(h), 505	2	
12. Highly Compensated	401(a), 120, 125, 129	4	
13. Highest 10% Compensated	505	1	
14. Highest 25% Compensated	105(h)	1	
15. Dependents	129	1	
16. Spouse or Dependent of 6, 9, or 12	125	1	

Appendix D

DEFINITION OF KEY EMPLOYEE
INTERNAL REVENUE CODE

§79 — Group Term Life Insurance

§105(h) — Uninsured Medical

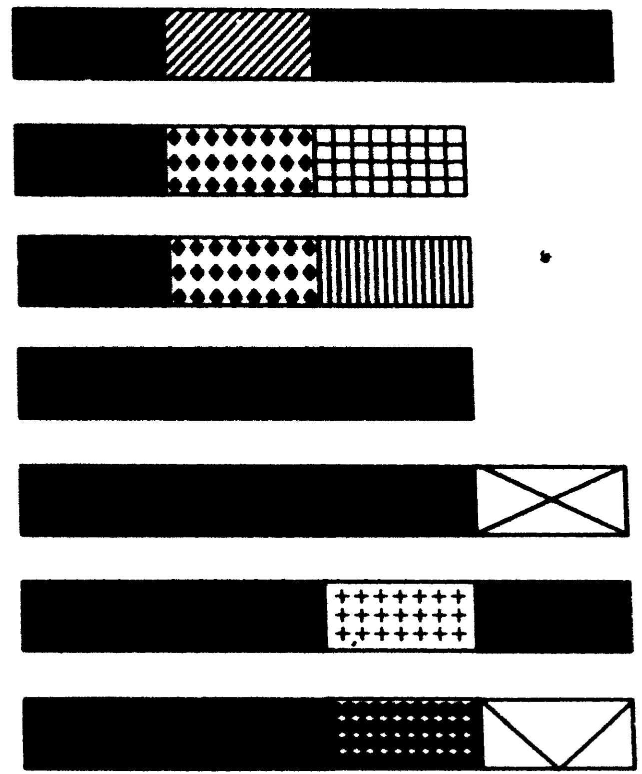
§505 — Funded Welfare Benefits

§401(a) — Qualified Pension & Profit Sharing

§120 — Group Legal

§125 — Cafeteria

§129 — Dependent Care



STATEMENT OF HAYDEN L. HANKINS, DIRECTOR OF EMPLOYEE BENEFITS, THE HALLIBURTON CO., DALLAS, TX

Mr. HANKINS. It is a great pleasure to be here today and have this chance to offer some comments and ideas on the six questions that you asked, Senator Packwood. I am the director of employee benefits for the Halliburton Co., an international company headquartered in Dallas, TX, with over 73,000 employees. The company was incorporated in 1924, is listed on the New York Stock Exchange, and is nonunion.

I would like to make brief comments in response to each of the six questions you asked. One, should the tax law encourage employers to provide fringe benefits and, if so, which benefits should be encouraged and what type and level of tax incentive is appropriate? We believe the tax laws should encourage employers to offer their employees benefit programs designed to help employees meet at least five broad categories of need. First to cover the extraordinary and largely unpredictable costs of necessary medical, dental, and legal services for themselves and their dependents. Second, to partially offset the loss of income resulting from disability or other circumstances severely impeding the person's ability to be self-supporting. Third, to provide family income protection in case of the death of the employee or spouse. Fourth, to help provide for the employee's retirement needs, including necessary medical, dental, and legal expenses. Fifth, to offer those additional programs that help build employee morale and foster a sense of well being such as free parking, subsidized food service, educational reimbursement, personal savings program, and so forth. The most important single tax incentive is to make the employer contributions to all nondiscriminatory programs tax deductible. Employee choice under flexible benefit programs that are easily understood and administered should also be encouraged. Finally, tax laws and regulations should be left in place without change to permit necessary management planning and commitment to establish and maintain whatever plans are chosen. Two, what conditions or restrictions are appropriate on tax incentives to encourage employers to provide fringe benefits? Many of the requisite conditions to encourage employers are already in place. The new tax law's clarification of what benefits are tax deductible is somewhat helpful.

A number of funding devices and programs are permitted by current tax law. These should be simplified whenever possible. None of them should be subjected to complex, hostile, or belated changes that do not serve the best interests of the public or private sectors. Three, are the existing rules concerning fringe benefits sufficient to ensure that all employees benefit fairly from the tax incentives? In general, the answer to this question is yes, especially if it is understood to mean full-time employees meeting reasonable eligibility requirements. ERISA's requirements are now generally understood and accepted and cover most critical areas. The preservation of the so-called flexible programs is important to encourage employee choice within limited financial resources. Nondiscrimination concepts that apply to eligibility and substantive plan features are also important. Freedom of choice, however, should be the main concern, not preconceived optimum results. Four, are the existing tax incentives for benefits such as health care, life insurance, day care, educational systems, and cafeteria plans effective in encouraging employers to provide these benefits to a broad cross section of employees at lower cost than if the Government provided the benefits directly? If employers provided these benefits on a taxable basis or employees purchased these benefits on their own? The answer is yes. There is overwhelming evidence that employers are providing a broad spectrum of benefits to their employees as confirmed by the Chamber of Commerce and other studies.

I wish to point out, however, that the Chamber's study is of hourly employees, and we have to assume that salaried people do at least as well. Considering the experience already observed by Government provided programs, it is hard to see how we can recommend Government alternatives. Without tax incentives, private benefits would escalate in costs dramatically. It is unreasonable to suppose that private employers would continue them voluntarily if they couldn't shift most of the cost to employees. If the employers were not involved, the employees would be put on the market to buy their own programs. Not only would they be very costly, but they are not offered in neatly designed packages carefully sculptured to meet their needs. There would also be a lot of problems with claim processing, and so forth. It is very difficult to envision any redeeming advantage of after-tax or Government-provided benefits as an alternative to the present system.

Senator PACKWOOD. Thank you very much. Mr. Biggins?

[Mr. Hankins' prepared written statement follows:]

STATEMENT
ON
HEARINGS ON FRINGE BENEFITS

HAYDEN L. HANKINS
DIRECTOR - EMPLOYEE BENEFITS
HALLIBURTON COMPANY

On Behalf of

HALLIBURTON COMPANY

Before The

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Washington, D.C.
June 26, 27, 30, 1984

The opportunity to submit written comments on behalf of the Halliburton Company to the Senate Subcommittee on Taxation and Debt Management in response to the six questions asked by the Chairman, Senator Packwood, is greatly appreciated. The issues raised are of great interest to the Halliburton Company, a nonunion employer of over 73,000 employees.

Since the overwhelming majority of employees in America are nonunion, the problems and concerns of the management of Halliburton regarding employee benefits are probably typical of most other companies.

Although Halliburton is a major international company, because it does not deal in consumer goods or services, it is possibly less well known than many others. So perhaps a few introductory remarks are in order. Halliburton was incorporated in 1924 as the Halliburton Oil Well Cementing Company. It has since expanded and grown into a diverse international company, is listed on the New York Stock Exchange and has operations throughout the United States and over 80 foreign countries. The main businesses of Halliburton are oil field services and products, engineering and construction services, both industrial and marine, and life and casualty insurance services. Because less than 51 percent of its business is manufacturing, it is not listed among the Fortune 500 companies, although it ranks among them in size and many other attributes. It does make the Forbes Market Value 500 and placed 149th in assets, 66th in sales, 43rd in market value and 37th in net profits.

In answering each of Senator Packwood's questions, an attempt will be made to elaborate on a given point only once even though it may be referred to in response to other questions, except insofar as some special aspect may warrant development on the narrower issue then under discussion.

Q-1 Should the tax law encourage employers to provide fringe benefits; and if so, which benefits or services should be encouraged and what type and level of tax incentive is appropriate?

A-1 Tax laws should encourage employers to offer their employees - on an employer paid, employee paid or shared cost basis, or some combination thereof - benefit programs designed to help employees meet at least five broad categories of need:

First, to cover the extraordinary and largely unpredictable costs of necessary medical, dental and legal services for themselves and their dependents;

Second, to partially offset the loss of income resulting from disability or other circumstances severely impeding the person's ability to be and remain self-supporting;

Third, to provide family income protection in case of the death of the employee or spouse;

Fourth, to help provide for the employee's retirement income needs and the ability to meet essential medical, dental and legal expenses during retirement, and

Fifth, those additional programs (many of which are provided at a minimum cost) that help build employee morale and foster a sense of well being.

The benefits that fall in each of the five categories are perhaps more self-evident in some cases than in others. In each instance, great variety can and should exist between organizations and no doubt new programs will evolve in the future if tax legislation is properly designed. Assuming the classes of programs that fall in the first category are self-explanatory, the second group would include sick pay, short and long term disability benefits, van pooling and child care programs. Family income protection, the third category, would include life insurance, accidental death and dismemberment insurance, immediate vesting of benefits under qualified plans, waivers of premiums on others and extensions of some group benefits. The fourth category includes profit sharing and retirement plans, employee savings plans on both a pre and after tax basis, payroll deduction IRAs as well as group life, medical, dental and legal programs for retired people. The final category is something of a catch-all, but is no less important simply because of that. In this area of benefits might be free parking, free or reduced price refreshments at break-time, subsidized food service, payroll deduction stock purchase plans, credit unions, payroll deduction IRA plans, ESOPs, discounts on company merchandise or services, recreational facilities and preretirement counseling programs.

The most important tax incentive is to make employer contributions to all nondiscriminatory benefits and services tax deductible. In some cases, such as employee contributions to an IRA or a deferred compensation program, current tax benefits are also needed for employees. In most cases, the critical incentive has to be given to the employer because it is the employer who is responsible for providing the benefits, administering them and generally bearing all, or a major portion, of the costs. This is very much the case at Halliburton, for example, where employee contributions represent only 16 percent of the discretionary benefit costs.

If there is a second point to stress regarding taxes, it is to leave tax rules and regulations in place for as long as possible so planning and commitment can occur. The net advantage to the Federal government to be derived from churning benefit related tax requirements is very difficult to see on the user end. If Federal revenues need to be increased, better channels must exist. If abuses are perceived, they should be punished. But many of the refinements and recharacterizations that have emerged in recent tax laws truly confuse the best qualified benefits managers and others charged with legal compliance. Most of the tax changes are totally lost on employees. They rely, and we want them to, on what we present to them. But many times unanticipated changes are difficult to make without accepting unjustified blame for government actions. For example, we just installed an ESOP for our domestic employees. All participants share equally in the funds provided. As part of our communications we said that the funds available would increase from .5 percent to .75 percent of eligible payroll in 1985, 1986 and 1987. Now we must explain that this will not happen. It makes us look indecisive, deceptive or cheap although that simply is not the case. This sort of thing turns a motivational program into a real employee dissatisfier. No management wants that in exchange for a tax credit.

Another case in point was the imposition of FICA taxes on savings under 401(k) plans. This still leaves a very real savings incentive, but everyone would have been better off if the tax standards had been set and maintained.

The present rule also creates an inconsistency between 401(k) savings and treatment of companion contributions under a flexible benefits plan - something no ordinary working person will keep straight.

Q-2 What conditions or restrictions are appropriate on tax incentives to encourage employers to provide fringe benefits?

A-2 As already stated, tax deductibility for employer costs and predictability are essential before employers will be encouraged by tax law to provide fringe benefits. The statutory tax exclusion of certain benefit plans has obviously encouraged their growth. Both the Labor Department and U. S. Chamber of Commerce studies confirm the high incident of medical and life plans largely caused by specific statutory exclusions, so the recent tax law additions were helpful on this count. It might have gone further to encourage innovation in the use of benefits to better meet the costs of socially desirable programs that are best met on a private group basis. This would include more reliance on private programs to adequately finance retirement and its attending costs, to help upgrade the education of working people to be better informed citizens as well as better employees and to help them face retirement in better shape physically, mentally and financially.

The principle of nondiscrimination has also been implanted into the regulatory scheme and is generally desirable. Variations should be permitted, however, when it is a matter of employee choice and to reflect differences in income in income-related programs. Moreover, differences in some programs should be permitted between broad categories of employees without meeting vague and unique special tests -

at least, for example, between those classes created by the Wage and Hour Law. This is not to suggest that all benefits will or should vary between such employee classes. The prevailing practice at Halliburton, and in many other companies, is very egalitarian. But at least a company subject to the Wage and Hour law ought to be able to follow the same guidelines between employee groups in offering benefits if it desired to do so without meeting any other specialized tests. This sort of consistency in the signals from Washington would help the cause of private benefit growth and development. Otherwise, you will continue to confuse the average employee by requiring different criteria between various benefit plans and/or other programs he may be eligible to join.

The funding mechanisms and programs permitted by Sections 125(g), 401(a), 401(k), 403(a), 405(a), 403(b) or 408(k) and 501(c)(9) should be continued. They should be supported by clear and simple regulations. This includes reasonable rules regarding pre-selected reimbursement accounts in flexible benefit plans so employees can better meet the cost of unknown but anticipated medical, dental, child care or legal expenses that are not otherwise covered. Without this kind of flexibility, a very valuable device for company and personal benefit cost control will be lost. At Halliburton our flexible benefit program does not include a reimbursement account, but we had hoped to offer one, subject to reasonable dollar or other limits. Since we do not have a group legal plan or child care assistance at Halliburton, our employees would only be able to pay medical/dental deductibles, medical/dental coinsurance, the cost of such uninsured items as eyeglasses and some child care. Since most people who work need their full pay to get by, these are unlikely to be frivolous or discretionary expenses. Single parents especially would find working a more fruitful experience if some of their child care costs were met on a pretax payroll deduction basis. The taxable income they will produce by working will far outweigh any revenue loss incurred by facilitating child care payments and think of the welfare costs that are avoided.

Q-3 Are the existing rules concerning fringe benefits sufficient to ensure that all employees benefit fairly from the tax incentives?

A-3 Assuming it is proper for reasonable eligibility requirements to be met, the answer to this questions is "Yes". Full-time employees, after very short service requirements, are typically eligible for all or most welfare benefits and ERISA has firm standards for participation in qualified plans.

Because of favorable tax laws and the other conditions we have mentioned, a great variety of employee benefits are now commonly offered by companies large and small. The 1982 survey of medium and large firms by the Department of Labor's Bureau of Labor Statistics showed virtually all companies provided health insurance, life insurance was about universal, 93% of all employees had some form of protection for long and short term disability, 84% of all employees were covered by pension plans, two-thirds of those with medical plans had dental plans, 75% of all employees had accidental death and dismemberment coverage and similar findings were found in the Chamber of Commerce survey of hourly benefits in 1982.

We have already mentioned nondiscrimination rules and the new top-heavy requirements should be clarified and limited to the special circumstances they address.

The rules that now limit benefits from or contributions to qualified plans to fixed dollar limits should be reviewed and indexed as soon as possible. In fact, they ought to be removed. No one can know what a truly proper retirement benefit ceiling is and left unadjusted, the limits will soon impact on the entitlements of middle class wage and salary people not intended to be disadvantaged by the Congress.

Moreover, such discriminatory rules miss their target; they simply lead to more reliance on nonqualified plans - plans that do discriminate and that are generally affordable only for the top few people even in relatively small companies. While such plans previously existed, their growth has certainly been stimulated by this act of legislative bias.

Q-4 Are the existing tax incentives for benefits such as health care, life insurance, day care, educational assistance and cafeteria plans effective in encouraging employers to provide these benefits to a broad cross section of employees at a lower total cost than if the Government provided the benefits directly, if employers provided the benefits on a taxable basis or employees purchased these benefits on their own?

A-4 There is overwhelming evidence that employers are providing a broad spectrum of benefits to their employees. Mention of the Department of Labor's findings has already been made. The Chamber of Commerce of the United States has been conducting surveys of hourly employees' benefits for thirty-five years. The results are often mistakenly cited as reflecting benefits for salaried employees as well. But it seems safe to assume that salaried people fare at least as well as the hourly, so the Chamber's findings become more a floor for benefits in America rather than a true average. In any case, the Chamber's 1982 study of 1,507 companies found that over 99 percent provide life and medical insurance and 83 percent provide pension benefits. In combination with other benefits, including those mandated by law, this translates into hourly benefits that cost employers 36.7% of payroll, or $3.52 per payroll hour or $7,187 per employee per year.

Even if the government could match employer costs, one cringes at the prospect of replacing the varied, competitive and ever-evolving mix of private benefits with a monolithic government substitute.

Considering just the cost question, however, the record in all developed countries speaks poorly for over-reliance on government managed schemes. Moreover, the true costs cannot be considered without some appreciation of the quality of service provided. In countries like Sweden with no private practice of medicine, for example, citizens have no choice but to queue up and to tolerate extended delays for non-emergency care. The same is true in other European countries. In England, where some private practice remains, going to a private physician is the much preferred solution to those fortunate few who either can afford it or have an employer who provides an insured alternative.

Developing accurate, timely, comparable cost data from country to country has proven to be extremely difficult. The most recent United Nations publication available was their Yearbook of National Accounts Statistics 1980 with most data dated 1979 or earlier. However, general indications are that social expenditures in European countries were an infinitely higher percentage of their gross national product than in the United States. But the records for government programs (exclusive of pure welfare) that resemble employee benefits in the United States is hardly trouble free. Consider just the cost problems associated with the unemployment compensation trust, medicare, veteran's hospitals, social security, federal employee pensions and the Railroad Retirement Act that should not require elaboration here.

On the other hand, if employee benefits were to be provided by employers on an after-tax basis, it would severely alter what most companies could or would afford. Much more of the cost of voluntary programs would have to be shifted to employees and even then many programs might have to be cut back to bare essentials. This is because adverse selection would keep raising costs for optional health benefits, dental care, life insurance and disability income benefits. Companies without benefits would actually gain an even greater competitive advantage - an edge they would be loathe to lose. But employees' wants and needs would not dry up and go away.

Employers forced to provide after-tax programs would suffer considerable competitive disadvantage with consequent jeopardy even to their business survival.

The idea of having employees individually buy their own benefits is quite unrealistic. Benefit programs do not exist in well-conceived packages on the open market. An individual might be able to buy some minimum health benefits, but would be at a total loss looking for comprehensive medical coverage comparable to what is offered to our employees, for example. Our plan is unique to Halliburton and is not replicated on the market. What can be said regarding the lack of good individual medical plans is even more true of dental benefits, AD&D, long term disability and so forth. Nowhere, to my knowledge, are assortments of all such programs offered for sale to individuals. But assuming carriers started to offer better individual plans, or even combinations of plans, employees would have difficulty identifying what programs were best to join, some would later prove to be financial failures, there would be much higher costs without employer support and even the process of paying premiums would be much more cumbersome without payroll deduction. Assuming all these hurdles were overcome, the kind of service offered would be generally inferior. Company benefits are administered in a pro-employee manner; company personnel are available to answer questions and to follow up when problems occur. Time off the job to see about claims is held to a minimun. The company maintains enrollment records so verification of coverage is automatic and so forth. All this and more would be lost by open market programs in place of employer-sponsored benefits.

5 How will tax laws that encourage employers to provide fringe benefits affect compensation planning?

5 Laws that encourage employer-sponsored benefits probably do not have any direct effect on compensation planning. The prevailing practice in most nonunion companies, and they are the vast majority, is to favor merit pay instead of general increases. Hence, planning for direct compensation involves reviewing the appropriate rate scales, possible competitive actions, business prospects and related matters and then establishing budgetary guidelines to be followed in making individual awards during a year's time.

Benefit planning is an entirely different exercise that involves meeting periodic group rate changes or actuarial requirements once a company has installed a particular program. There is an old axiom in personnel work, that "What management granteth it cannot taketh away". It is uncommon for a company to put in benefits one year and cancel them the next. If there is a union, they cannot and companies without unions simply do not take away benefits, not if they intend to stay in business and do not want to destroy the confidence and morale of their employees. However, negative or confusing tax laws will discourage the establishment of benefits or extending existing plans if the tax consequences are unclear.

In short, once benefits are in place, meeting the company's share of costs as they may change to meet evolving exposure and experience is more a matter of company commitment to an employee program than an annual review of how much the company is willing to spend. This does not mean, however, that unexpected benefit costs do not get management's attention. A case in point is the rising costs for health care which have produced a growing number of business coalitions and the introduction of cost containment features in many existing medical plans.

Again, this underscores the need for understandable tax rules that can be counted on as staying in place.

Q-6 Will tax incentives for employer provided fringe benefits affect potential employees' choice of employment?

A-6 Tax incentives alone will not alter the behavior of job seekers. Most Americans remain remarkably innocent of the enormous complexities of the IRS tax code in the benefits area. A significant factor in companies offering and continuing to offer benefits, especially above and beyond marginal levels, has to be attracting and retaining good employees. This motivation may even overcome the difficulties and uncertainties changing tax laws create.

In any event, benefits offered certainly do affect employees in their choice of jobs. This is especially true of currently employed people, highly qualified applicants and others who have a choice of possible employers. By the same token, an employer has to keep the faith with his employees to command their loyalty so employers do not normally play games with their benefit programs. While any simple assessment has exceptions, it is often the exceptions that get so much legislative attention. Despite the excellent record of most employers in utilizing flexible benefit programs, it was the few companies who went too far by establishing open-ended reimbursement accounts that caused the rash of legislative proposals here in Washington. That kind of reimbursement account, sometimes called ZEBRAs, should be restricted. The reaction in Washington, at least initially, was a lot of legislative proposals that would have done irreparable damage to flexible concepts across the board, punishing the prudent majority along with the imprudent few. Especially given the history of Section 125(g), the long period of little use and then virtually no administrative guidance, the proponents of this particular form of legislative overkill cannot have seen the problem in balanced perspective. While many other examples might be cited, hopefully this suffices to illustrate the importance of evaluating the good along with the bad. What is desparately needed is a reaffirmation by the Congress of their support for the major role played by private benefits in the economic and social well being of working Americans and Congress's commitment to promote the development and growth of private benefits in the years ahead. In addition to the traditional forms of benefits provided by employer sponsors, much could be said for encouraging the growth of IRA type devices to meet peoples' retirement income needs and to supplement their retirement medical expenditures as the problems with medicare become more and more prevalent. There are, of course, some risks with this approach. There are always risks, but government solutions, however well intended, are floundering everywhere because they suffer from certain inherent and inescapable problems that do not afflict the private sector.

One of these difficulties is the demographic trend toward an older population because of declining birth rates and because people keep living longer. While the rate of change in the current ratios between workers and retirees varies between countries, this is a worldwide problem in all developed societies. Even outside the area of retirement-associated benefits, where this problem is generally recognized, virtually all government transfer payments from workers to nonworking recipients suffer from the growing imbalance between the two groups as more government programs are developed or existing ones expanded. By contrast, in private plans the benefits are designed to help those in the group who are working and contributing to the cost of the programs. Moreover, in the case of retirees, the benefits come from funded trusts or individual IRAs, not from contributions currently made by some worker or workers who are totally unrelated to the recipient.

The second unavoidable dilemma for government plans in a free society is the method of financing. Government plans worldwide tend to be "pay as you go" in nature. There is no acceptable mechanism for creating adequate funds to meet future exigencies. If we had an increasing number of workers per retirees or beneficiaries, the problem might be manageable, but the exact converse is true and it is merely going to get worse. Even if by some miracle, excess funds could be created for a government-sponsored plan, there is no legitimate investment outlet for them. If there were surplus funds in the social security trust fund, in the medicare trust fund or the unemployment compensation trust fund, there is no way those monies can be invested at a true profit without leading to government ownership of the means of production. That would mean the destruction of the economic core in order to promote social programs for a few - a totally untenable approach that has not, to my knowledge, been undertaken in any developed country outside the Communist sphere. By contrast, monies that are put aside for the future payment of benefits in private plans are put to work in the private economy. They are invested and reinvested to provide capital for growth and development and stimulate economic activity. This is true whether the surplus money is held in a trust fund, an insurance account, in an individual IRA, a savings plan, a pension program or a profit sharing plan. When the question of raising tax revenues is discussed, recognition should be given to the fact that encouraging private benefit financing stimulates the economic activity of the country and clearly serves to enlarge the tax base. In fact, withdrawing all these funds from private hands would have a very depressing effect on economic activity from which we might not easily or ever fully recover.

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STATEMENT OF PETER BIGGINS, DIRECTOR OF PERSONNEL PLANNING, THE LTV CORP., DALLAS, TX

Mr. BIGGINS. Thank you, Senator. I am director of personnel planning for the LTV Corp. in Dallas, TX. And the purpose of my statement is to set forth LTV's views on the subject of employee benefits. LTV provides its employees with flexible compensation through a cafeteria program, and my statement will focus on this approach to the design of the employee benefits. I want to talk about two subjects—cafeteria plans in general and especially one of the options under our program—the Benefit Bank—which is also referred and has been referred to earlier today as an FSA or a flexible spending account.

Employers like LTV have become increasingly concerned about the devaluation of their compensation dollar that has come about through the growth of inflexibilities in their compensation programs. In 1978 and in 1980, Congress passed landmark legislation that enabled employers to restore flexibility to their programs through cafeteria benefit programs. Since January 1, 1983, LTV has offered its employees a state-of-the-art cafeteria program. It is our considered judgment that we are now getting a lot more for our compensation dollar because employees are better able to allocate our dollars than we are. Moreover, they are now actively participating in their benefit programs and helping themselves. Benefits provided under this cafeteria plan have not reduced Federal revenue and there is data in my prepared statement to back that up. And I won't go into that now.

I would like to move on to the benefit bank. One of the most important parts of our program is the benefit bank and it is absolutely critical to our efforts to manage health care costs. In response to our IRS concerns as to potential revenue loss, we suggest that Congress consider a qualified plan approach. We would be pleased to work with you to develop the details, but first, a little bit of background.

LTV provides base health care benefits for all employees, retirees, and their dependents. To reduce overuse of the health care system, the company has been replacing its first-dollar health insurance plans with a new plan that provides for (1) advance approval of hospitalization and (2) cost-sharing for other health care. The design savings, which amount to about 10 percent of the cost, are passed on to the employees through an addition to supplemental salary, which is a part of our cafeteria plan. Utilization savings which are about 10 percent of the cost of the plan are retained by the company. Redesign of health care benefits has had a major impact on employees because it has shifted risk to them. LTV would probably not have made such a drastic change, had it not been for the availability of a benefit bank. With a benefit bank, the employee may make deposits to a personal account and request withdrawals for deductible amounts, copayments, and other health care expenses.

The pay used for deposits and the amounts withdrawn for health care are tax-free, just as if the company had provided health care benefits directly. The employee has an incentive not to use his or her account because the unused balance is refunded at year end.

The refund is taxable. I might add that the bank also provides for day care expenses and legal service expenses. The change to the new health care plan and the adoption of the benefit bank affect Federal revenues in two ways. First, there is an increase in Federal revenues from corporate income taxes due to utilization savings. These company savings increase LTV's taxable income and generate a corporate tax liability.

There is a decrease in Federal revenue due to the fact that the benefit bank is used for more than what was cut out of the base health care plan. This added usage decreases employees' taxable income and generates an employee tax saving of about $75 per employee per year.

The net effect is to increase Federal revenues by about $50 per employee per year.

In closing, I would like to suggest that a third approach—aside from the use-it-or-lose-it approach that was adopted through IRS regulations and the Conable-Packwood proposal—be considered for benefit banks, and that is the qualified plan approach. And I have included in my statement a series of suggestions as to what might be included in this qualified plan approach. Thank you.

Senator PACKWOOD. Thank you very much. Mr. Howard?

[Mr. Biggins' prepared written statement follows:]

STATEMENT OF PETER A. BIGGINS
IN CONNECTION WITH THE HEARINGS
OF THE SENATE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
ON THE SUBJECT OF FRINGE BENEFITS
JULY 26, 27, and 30, 1984.

My name is Peter A. Biggins. I am Director - Personnel Planning for the LTV Corporation, P. O. Box 225003, Dallas, TX 75248. The purpose of my statement is to set forth LTV's views on the subject of employee benefits. Since January 1, 1983, LTV has been providing certain employees with flexible compensation through a "cafeteria" benefit program, and my statement will focus on this approach to the design of employee benefits.

Development of Cafeteria Plans

There was a time when compensation was perfectly flexible. Salary was the only source of compensation. The employee had complete freedom to use it as he or she wished. Both the employer and employee got full value from compensation.

Then, two things happened. Employers started to provide employee benefits instead of salary, and government started to impose a tax on compensation. Benefit programs were provided because employers felt a responsibility to take care of employees. In general, compensation used directly by employers for benefits was nontaxable.

Group benefits were accorded favorable tax treatment to keep government-sponsored programs to a minimum.

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Employer-selected benefit programs flourished and compensation as a whole became inflexible. Without freedom of choice, the mix of benefits became less than optimal for most employees. Compensation dollars produced less than full value for employers and employees.

Inflexible group benefit programs, including employer contributions to government programs, got to be 37% of base pay. And, based on a recent survey by Opinion Research Corp., 69% of those surveyed thought their employer spent less than 20% of their pay on benefits, and another 19% just didn't know.

About ten years ago, a few employers started questioning the system. They saw that they were getting less than full value for their compensation dollar because the benefit programs they selected on a group basis weren't exactly meeting the needs of individuals in a changing workforce. They wondered whether they could trust their employees to design their own benefits. After holding discussions with groups of employees, they found that their employees wanted and were able to take care of themselves. They realized that their new computers were well-suited to keeping track of employee-chosen benefits and that their employees were willing to interface with their computers. Cautiously, they decided to convert a small part of their inflexible group benefit dollars into a supplemental source of compensation that employees could use individually to buy the benefits that they wanted.

These pioneering employers saw that the tax laws were holding them back. Employee choices had to be limited to just taxable uses or just nontaxable uses. Employees could not choose between taxable and nontaxable uses without rendering the nontaxable uses taxable. In 1978 and 1980, Congress responded to the concerns of these employers by enacting legislation that allowed choice between taxable and nontaxable uses, thereby enabling a quantum leap in the development of cafeteria plans.

The trend toward flexibility is in its infancy. Only a hundred or so employers have converted from inflexible group benefits to a flexible compensation source, and those that have have converted no more than about 10% or 20% of their benefit dollars.

There are signs, however, that a major trend is beginning to develop. Employees understand and want choices. Employers are becoming more trusting and willing to let go of their benefit design strings. The experience of the pioneers is very favorable in terms of both employee acceptance and administrative capability.

The purpose of this statement is to describe the LTV cafeteria benefit program and its impact on LTV, LTV employees, and Federal revenues. Before doing so, however, it will be helpful to establish some basic concepts of compensation.

Two Sides of Compensation

There are two sides of compensation, sources and uses. Sources are where the money comes from, and uses are where the money goes. Sources of compensation include base pay, overtime, bonuses, and the dollars spent by an employer on base employee benefits. Uses of compensation include take-home pay, taxes, payroll deductions for optional benefits, and the base benefits purchased with employer dollars. The total of uses equals the total of sources.

To make compensation more flexible, some employers have converted part of one compensation source, base benefit dollars, into a new compensation source that the employee can allocate to a variety of uses. This new source goes by various names: flexible credits, company contributions, benefit bank, supplemental pay, etc.

Taxation Dependent Upon Use

Compensation sources are taxable or nontaxable according to their use. A use that makes compensation sources taxable is called a taxable use. One that makes compensation sources nontaxable is called a nontaxable use. According to current Federal income tax law, compensation uses are divided into nontaxable and taxable uses as follows:

Nontaxable Uses	Taxable Uses
o Health care	o Employee life insurance over $50,000
o Legal services	o Spouse life insurance
o Day care	o IRA capital accumulation (tax-deductible)
o Disability income	o Regular after-tax capital accumulation
o Employee life insurance up to $50,000	o Take-home pay
o Accident insurance	o Taxes
o Pension	
o Tax-deferred capital accumulation - 401(k)	
o Vacation	

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Base benefits provided by employers are of the nontaxable variety with the exception of employee life insurance over $50,000. Optional benefits historically have been of the taxable variety because of the tax laws.

Since the Federal income tax laws were changed in 1978 and 1980, nontaxable benefits retain their tax effectiveness when they are offered as optional benefits, regardless of whether they are offered as an alternative to taxable uses. Before that, benefits that were nontaxable as base benefits became taxable if offered as an option along with taxable benefits and cash uses.

Social security taxation is the same as Federal income taxation with one exception. The 1983 social security legislation included tax-deferred capital accumulation in the social security wage base if the employee has an option.

Inflexibility in Compensation

Flexible compensation is the absence of inflexibilities in sources and uses. There are eight kinds of inflexibility: base benefits, source segregation, limited options, option bundling, benefit maximums, price subsidies, timing restrictions, adverse selection.

Base benefits are inflexible because sources are earmarked for uses. With mandatory group benefit programs, the employer's compensation dollars are automatically spent on specified benefits. This inflexibility can be reduced by converting base benefits into supplemental pay.

Source segregation exists when the source of compensation available for certain uses is restricted. Without the 1978 and 1980 changes in Federal income tax laws, flexible compensation programs could not get rid of source segregation. Supplemental pay, the new source created out of reduction in base benefits, had to be spent on nontaxable uses only. And, base pay had to be spent on taxable uses only (taxable benefits and take-home pay). The tax laws no longer produce this inflexibility.

Limited options occur simply when an employer does not offer the full range of "effective" optional benefits. Optional benefits are effective when, relative to purchase apart from the employer, they have tax advantages, cost less, or can be purchased more conveniently through payroll deduction. Only a few employers offer all such options that are available.

Option bundling is the putting together of two or more options in one option. This is done to simplify the administration and communication of the program and to avoid adverse selection.

Benefit maximums limit flexibility in that an employee cannot purchase as much of an optional benefit as he or she would like. The most common benefit maximums are those imposed by law on nontaxable benefits to limit discrimination in favor of higher-paid employees (health care spending account, nontaxable life insurance, tax-deferred capital accumulation, and IRA). Maximums are also imposed when employers wish to limit overuse of benefits (health care and disability income).

Price subsidies reduce flexibility because, if the price of a benefit is subsidized, the employee feels more compelled to select it. One example is employer matching of employee contributions to a capital accumulation plan. Another is pricing that does not vary by age for an age-related benefit like life insurance. When uses are priced without subsidy, true flexibility is obtained.

Timing restrictions are a form of inflexibility. If the employee cannot change a benefit selection when his or her needs change, then there is inflexibility until the change can be made. Some "flexible" benefit programs operate on an annual basis with no changes allowed during the year. Some timing restrictions are necessary to limit adverse selection of health care, disability income, and life insurance.

Adverse selection occurs with insurance options. Flexibility is diminished when employees can predict the occurrence of the event insured. For example, if eyeglass insurance were offered and employees could predict their need for eyeglasses, the option price would rise to the actual cost of eyeglasses. Those who do not need eyeglasses would not buy the option. Those who do would buy it. Furthermore, there would be a tendency for the price to rise to the highest cost of eyeglasses as those with lowest cost dropped out and bought eyeglasses cheaper without insurance. This is called adverse selection. It renders this type of "insurance" ineffective as a flexible use. The result is no flexibility. On the other hand, when the occurrence of the insured event is not predictable, there can be no adverse use selection, and flexibility is retained.

Adverse selection can be reduced by packaging the insurance with other uses, by requiring advance selection before the event can be predicted, by requiring evidence of good health, or by subsidizing the price. All these methods of reducing adverse selection, however, create other kinds of inflexibility.

There is no clear-cut definition of flexible compensation. It's a matter of degree. The fewer the inflexibilities, the more flexible the program.

LTV Employee Benefits

The LTV Corporation is a diversified operating company involved in three basic lines of business--steel, aerospace/defense and energy products.

The company is a primary supplier of steel products to the automotive, appliance and construction industries; missiles, aircraft components, tactical wheeled vehicles and electronics to the defense and commercial aerospace markets; and tubular products, oil field supplies and drilling and production equipment to the petroleum industry.

LTV employs approximately 68,000 employees in the United States. About 13,000 are located in Texas, 24,000 in Ohio, 11,000 in Pennsylvania, 8,000 in Indiana, 5,000 in Illinois and the remainder are scattered throughout many other states. Together with dependents and retirees, over 300,000 Americans are protected by various LTV employee benefits, including pension, profit sharing, savings, health care, life insurance, disability income, vacations, holidays, day care, and legal services. Some of these benefits are nontaxable benefits, and some are taxable. While not all employees have all the benefits, the benefits are available to and used by a broad cross-section of employees, whether they be low-paid or high-paid, female or male, black or white, single or married, old or young. Less than 2% of our employees earn over $50,000 a year. About 70% of our employees have 10 or more years of service and are vested in an LTV pension.

LTV benefit programs have grown primarily as a response to employee needs for (1) income maintenance in the event of retirement, death or disability, (2) protection against unexpected health care costs, and (3) time off for rest and recreation. They are secondarily a response to income tax advantages made available by Congress over the years for social purposes. If the tax advantages had not been made available by Congress, some of the benefit programs would not exist, some would not provide the same level of protections, and some would not cover as many employees.

LTV Cafeteria Program

Like the compensation programs of most other companies, the programs at LTV became increasingly inflexible, as monolithic benefit programs grew over the years at a faster pace than direct pay. Today, employee benefit dollars exceed 40% of direct pay.

These employee benefit dollars are a part of LTV's total compensation resources. As an economic entity, LTV is very concerned about maximizing the value of its compensation resources. We believe that employee benefit dollars are better spent if allocated by employees individually to the benefits that they need. We trust our employees' abilities to determine their own needs and to select benefits to meet those needs.

With the changes in the tax laws in 1978 and 1980, LTV has been able to construct a whole new kind of compensation program for its employees. Called "Design Your Benefits," it provides employees with choice by providing two types of benefit programs:

- o Base benefits automatically provided by LTV

- o Optional benefits that employees can select to meet their individual needs.

Supplemental--or extra--pay is provided to employees to help purchase optional benefits or simply to increase their take-home pay. Supplemental pay was created by reducing base benefits from the levels formerly provided by LTV. The pay, whether base or supplemental, that an employee uses to purchase "nontaxable" benefits is nontaxable (tax-free or tax-deferred). The pay used for "taxable" benefits or take-home pay is taxable.

Base benefits still provided by LTV are health care (tax-free), disability income (benefits payments taxable), profit sharing (tax-deferred), retirement income (tax-deferred), and vacations and holidays (taxable). Optional benefits include a benefit bank for health care, day care, and legal services (tax-free); health maintenance organizations (tax-free); supplemental disability protection (benefits payments taxable); life insurance protection for employees (tax-free up to $50,000, taxable over $50,000) and spouses (taxable); accidental death insurance protection for employees (tax-free) and spouses (taxable); capital accumulation under IRS code Section 401(k) (tax-deferred); Individual Retirement Account (tax-deductible); after-tax capital accumulation (earnings tax-deferred); and optional vacation (taxable when taken).

Supplemental pay is paid each pay period with base pay. The costs of optional benefits are deducted from pay each pay period. In general, employees can start, stop, or change optional benefit selections at any time.

The new "Design Your Benefits" program began on January 1, 1983, for 6,600 employees in the LTV Aerospace and Defense Company (Vought aero products division and Vought missiles division) and for 300 employees in LTV's corporate headquarters. It began on October 1, 1983 for 5,300 employees in LTV's steel group (former Jones & Laughlin Steel Corporation). It began on July 1, 1984 for 2,000 employees in the LTV Energy Products Company. The program will be introduced elsewhere within LTV in the future.

LTV Cafeteria Results

We have now had a year and a half of experience with "Design Your Benefits" and are confident that it is meeting our expectations. The creation of supplemental pay has shifted an average of 4% of base pay from inflexible base benefit dollars to the new flexible compensation source. The range is from 2% to 9%, depending on age, service, and organizational unit.

That employees reallocated the benefit dollar to better serve their needs is confirmed by a variety of selection results for the Vought divisions:

- 45% of employees took more life insurance than they had before and 33% took less. Only 22% bought back the same amount.

- 33% of employees who could buy more vacation than they had before did so. Forty percent of employees who could buy less than they had before did so.

- 63% of employees who could buy more disability protection than they had before did so. Twenty-one percent who could buy less did so.

- Many employees added entirely new protection under "Design Your Benefits" that they did not have under the old program.

  - 63% chose the benefit bank. Practically every participant used it for health care, 11% of participants used it for legal services, and 7% of participants used it for day care. Ninety-one percent received refunds at year-end.
  - 57% chose spouse life insurance.
  - 73% chose employee accident insurance.
  - 50% chose spouse accident insurance.
  - 37% chose tax-deferred capital accumulation.

- Some employees even increased their participation in capital accumulation options that existed already in the old program.

  - Participation in the IRA increased to 31% of employees from 23%.
  - Participation in the regular after-tax capital accumulation increased to 40% from 31%.

- Two out of three employees participate one way or another in the capital accumulation options.

In offering "Design Your Benefits" to employees, we trusted them to assess their own needs and make selections. We tried to keep the program as simple as possible. Seventy-seven percent of the employees thought the program made sense. Seventy-five percent thought the written materials were easy to read. Almost everyone made use of a programmed-learning workbook that allowed them to calculate their first compensation statement in advance.

The compensation statement is attached to each paycheck the employee receives and shows the employee's base and supplemental pay for the pay period and year to date, the level of optional benefits selected, and the amount of payroll deductions for the period and year to date. The purpose of the statement is to regularly remind the employee of the selections. The employee is free to change optional benefits at any time, subject to health evidence requirements for life insurance and disability protection.

There is no way to prove conclusively that LTV is getting more for its compensation dollar with "Design Your Benefits," but it is our considered judgement that we are getting a lot more not only because employees are better able to allocate our compensation dollar but also because they are actively participating and helping themselves.

The average cost of implementing "Design Your Benefits" is about $75 per employee. As more employees are added to the program, the average cost will decline due to the spreading of developmental costs.

LTV Tax Revenue Effect

There is concern among some observers about a potentially large revenue loss that could occur as a by-product of a possible trend toward programs like "Design Your Benefits" and possible discrimination in favor of higher-paid employees. We would like to take this opportunity to share certain statistics from "Design Your Benefits" that indicate what we believe to be minimal impact on tax revenues to the Federal government.

First, employees are not just grabbing all the nontaxable benefits they can get. In fact, they are actually using far less than the nontaxable benefits they could potentially select. The average annual payroll deduction selected by employees of the Vought divisions for nontaxable optional benefits under Section 125 is $1,168 out of a possible $6,269. Employees are selecting only 19% of the potential nontaxable benefits. The table below shows a summary by type of benefit.

Nontaxable Benefit Option	Annual Potential	Annual Actual	Percent
Benefit bank*	$5,390	$ 584	11%
Disability income	43	30	70
Employee life insurance	185	165	89
Employee accident insurance	79	56	71
Vacation	572	333	58
	$6,269	$1,168	19

* Actual benefit bank usage is $505 for health care, $53 for dependent care and $26 for legal services.

These figures should allay any fears that employees are selecting benefits with the sole objective of avoiding taxable income. It should also be noted that employees are participating equally as much in taxable options. Average annual payroll deductions for other benefits are: employee life insurance over $50,000 ($231), spouse life insurance ($109), spouse accident insurance ($10), and regular after-tax capital accumulation ($818). In addition, the average annual payroll deductions for qualified nontaxable options are as follows: tax-deferred capital accumulation under Section 401(k) ($657) and IRA capital accumulation ($604).

Second, the estimated revenue loss for nontaxable benefits covered by Section 125 is $1 a year per employee. The average nontaxable income per employee per year that is related to the availability of Section 125 is as follows:

Nontaxable Benefits	Without Sec. 125	With Sec. 125	Increase or (Decrease)
Benefit bank - Health care	$ -	$ 505	$505
Day care	-	53	53
Legal services	-	26	26
Disability income*	26	30	4
Employee life insurance	185	165	(20)
Employee accident insurance	-	56	56
Spouse pension*	56	-	(56)
Vacation*	319	333	14
Base health insurance	2,363	1,785	(578)
	$2,949	$2,953	$ 4

* Excludes that portion of the base benefit that has remained the same.

Based on an assumed marginal tax rate of 35% for Federal income taxes, the estimated annual revenue loss per employee is $1. Practically speaking, there is no revenue loss.

In summary, we believe the experience that LTV has had with flexible benefits indicates that employees in companies like LTV will not substantially erode the income tax base through cafeteria plans allowed under Section 125. We believe that Section 125, including the use of salary reduction, should remain as an integral part of our national tax policy because it enables employers to maximize the value of their compensation dollars by allowing employees to choose benefits that meet their needs. We ask that programs like LTV's "Design Your Benefits" be allowed to develop without arbitrary limitations.

Health Care

LTV provides base health care benefits for all employees, retirees and their dependents. To reduce overuse of the health care system, the company has been replacing its first-dollar insurance plans with a new plan that provides for (1) advance approval of hospitalization and (2) cost sharing for other health care. There is an annual deductible for non-hospital medical expenses equal to 1% of annual base pay, followed by 20% employee co-payments. These co-payments stop, however, when they amount, in a year's time, to 2% of annual base pay. The design savings (about 10%) are passed on to the employees through an addition to supplemental salary. Utilization savings (about 10%) are retained by the company.

The company has not offered optional health insurance plans that have varying degrees of cost sharing for two reasons. First, we wanted to obtain utilization savings for all employees now, not just those who happen to select the options that have a higher degree of cost sharing. Second, we were concerned about the cost of adverse selection. We felt that employees in poorer health would select lower cost sharing and that, no matter where we set the price of the options, we would get "out-selected".

Benefit Bank

Redesign of health care benefits has had a major impact on employees because it has shifted risk to them. LTV would probably not have made such a drastic change had it not been for the availabilty of a "benefit bank". With a benefit bank, the employee may make deposits to a personal account and request withdrawals for deductible amounts, co-payments, and other health care expenses. The pay used for deposits and the amounts withdrawn for health care are tax-free, just as if the company had provided health care benefits directly. The employee has an incentive not to use his or her account because the unused balance is refunded at year-end. The refund is taxable.

Revenue Impact of Benefit Banks

The change to the new health care plan and adoption of the benefit bank affect Federal revenues in two ways.

1. There is an increase in Federal revenue from corporate income taxes due to utilization savings. These company savings amount to about $250 per employee per year. This increases LTV's taxable income and generates a corporate tax liability of about $125 per

employee per year. Design savings to the company can be ignored because they have been passed on to employees through added supplemental pay.

2. There is a decrease in Federal revenue due to the fact that the benefit bank is used for more than what was cut out of the base health care plan. This added usage amounts to about $225 per employee per year. It decreases employees' taxable income and generates an employee tax saving of about $75 per employee per year.

The net effect is to <u>increase</u> Federal revenues by about $50 per employee per year ($125 - $75 = $50).

The Internal Revenue Service is concerned that benefit banks will decrease Federal revenue. Though our experience and that of other companies has been just the opposite, there is a potential for revenue decrease in certain situations. For example, if a company were to introduce a benefit bank without redesigning its base health care plan, there would be no utilization savings to increase the company's tax liability. In such a situation, the benefit bank simply would be making available to employees new nontaxable benefits. If LTV were to make a benefit bank available without redesigning its base health care plan, there would be a Federal revenue loss of about $75 per employee per year.

While my experience would indicate that few benefit banks have been established without redesign of the basic health care plan, it is appropriate for the IRS to be concerned about <u>potential</u> revenue loss.

IRS Benefit Bank Regulations

Several solutions have been put forth to prevent this potential revenue loss. The IRS has adopted a regulatory solution which is designed to make benefit banks unattractive. The regulations require that deposits that remain unused at the end of the year be forfeited. This concept is called "use it or lose it". If allowed to continue, those regulations will discourage the use of benefit banks as a device to ease the implementation of more cost-effective base health care plans. The trend toward cost sharing will be halted and perhaps reversed.

Companies will still adopt benefit banks, but employees will tend to use them for more predictable health care expenses, such as orthodontia, elective surgery and vision care. Employees will be encouraged to overuse health care at year end because of the "use it or lose it" requirements, and the IRS will lose tax revenue it would have received on year-end refunds. There is a greater likelihood for revenue loss with this solution than without it.

Benefit Bank Cap

Various legislative proposals have been discussed that would place an annual cap, such as $2,000, on the amount that could be paid from a benefit bank for health care. While the cap approach is much better than "use it or lose it", there are some problems with it. The benefit bank may lose its attractiveness and not foster redesign of base health care plans. The cap particularly hurts the employee who has incurred catastrophic expenses.

The Qualified Benefit Bank

A third approach is referred to as the "qualified plan" approach. Under this approach, both the company's base health care plan and benefit bank would have to meet certain cost-effectiveness requirements to be able to offer a benefit bank for health care. As a suggestion, first-dollar benefits might be allowed in the base plan only when there is an effective utilization review program, benefits are for preventive care, or benefits are for a mandatory second opinion on elective surgery. Further, cost-sharing would have to meet certain minimum requirements. In addition, certain exclusions and limitations would be applied to benefit banks, similar to some of those that exist in base health care plans. For example, cosmetic surgery could be excluded and eyeglasses could be limited to $75 a person every two years. A more detailed list of the suggested qualifications is attached.

Without benefit banks, the trend toward cost-effective health benefits would virtually come to a halt and might even be reversed. If qualified benefit banks remain nontaxable, however, there will be a strong incentive for employers with first-dollar insurance programs to resume the redesign of their programs. Employers will increase the use of nontaxable cost-sharing insurance if they can add benefit banks to ease the transition. They will use the cost saving to reduce taxable employee contributions, increase base pay, or create a nontaxable employer contribution to the benefit bank. And, they will allow employees to add to their benefit bank accounts through nontaxable salary reduction under a "cafeteria" program.

The introduction of more cost-sharing (through benefit banks) will increase the use of nontaxable HMO's and other alternative delivery systems. HMO's are much more appealing as alternatives to cost-sharing insurance than as alternatives to first-dollar insurance. They are a way of retaining first-dollar protection. So, employers will offer more HMO options and more employees will select HMO options. Employers will allow employees to make nontaxable employee contributions for the HMO option under a "cafeteria" program through salary reduction or withdrawals from benefit bank accounts.

Some employers will retain first-dollar insurance but on a qualified nontaxable basis. They would do this through use of predetermination of benefits, and preferred provider organizations that meet HHS utilization review standards, inclusion of preventive care benefits, and mandatory second surgical opinion.

Summary

Employers have become increasingly concerned about the devaluation of their compensation dollar that has come about through the growth of inflexibilities in their compensation programs. In 1978 and 1980, Congress passed landmark legislation that enabled employers to restore flexibility to their programs through "cafeteria" benefit programs. Since January 1, 1983, LTV has offered its employees a state-of-the-art cafeteria program. It is our considered judgement that we are now getting a lot more for our compensation dollar because employees are better able to allocate our dollars than we are. Moreover, they are now actively participating in their benefit programs and helping themselves. Benefits provided under the cafeteria law have not reduced Federal revenues.

One important part of our program, a "benefit bank," is absolutely critical to our efforts to manage health care costs. In response to IRS concerns as to potential revenue loss, we suggest that Congress consider a "qualified plan" approach and would be pleased to work with you to develop the details.

ATTACHMENT

Suggested Qualifications for Benefit Banks

1. First-dollar insurance benefits must meet the requirements of a, b, or c:

   a. Benefits are administered by an employer, an insurance carrier, or a third-party administrator that has adopted an independent utilization review program that meets standards established by HHS.

   b. Benefits are for preventive care, such as physical exams, Pap smears, and teeth cleaning.

   c. Benefits are for the cost of obtaining a mandatory second opinion as to the need for elective surgery.

2. Cost-sharing insurance benefits must meet the minimum cost-sharing requirements of a, b, or c:

   a. Benefits are subject to an annual deductible equal to at least 24 times the average straight-time hourly pay rate in effect at the beginning of the plan year.

b. Benefits are subject to at least 25% employee co-payments, until the co-payments exceed 48 times the average straight-time hourly pay rate in effect at the beginning of the plan year.

c. Benefits are subject to both deductible and co-payment:

(1) An annual deductible equal to at least 16 times the average straight-time hourly pay rate.

(2) At least 15% employee co-payments until the co-payments exceed 32 times the average straight-time hourly pay rate in effect at the beginning of the plan year.

The same minimum deductible or maximum co-payment would apply to all employees without regard to family size. A higher minimum deductible or maximum co-payment could be adopted for larger family units at the discretion of the employer.

The minimum deductible or maximum co-payment could be pay-related at the discretion of the employer.

The same minimum deductible and maximum co-payment would apply regardless of the scope of benefits to which they apply.

Separate deductibles could be adopted for separate benefits as long as the deductible amounts bore a similar relationship to their respective covered expenses and the total of the deductibles was not less than the minimum requirement.

A schedule of benefits could be used to meet the minimum co-payment requirements if the average payment by employees over the scheduled amount is at least as large as the minimum requirement.

3. Benefit banks must meet the requirements of a, b or c:

   a. Health care withdrawals exclude expenses not normally paid by insurance plans and HMO's: home and vehicle improvements, cosmetic surgery, amounts in excess of reasonable and customary charges, special foods, nursing and special homes, and transportation other than ambulance service.

   b. When added to insurance benefits, health care withdrawals are limited for (1) eyeglasses to $75 per person once every two years and (2) orthodontia to $1,000 for each person.

   c. Unused deposits in benefit banks are non-forfeitable and refunded at year-end in the form of cash or transfer to a capital accumulation plan.

The entire health care benefit program would have to qualify under these rules for the benefit bank to be nontaxable.

STATEMENT OF ROY B. HOWARD, ASSISTANT VICE PRESIDENT, PERSONNEL, BELLSOUTH CORP., ATLANTA, GA

Mr. HOWARD. Mr. Chairman, I appreciate the opportunity to appear before the subcommittee to present my company's views on the fringe benefit issues which you have raised.

I am Roy B. Howard, and I am assistant vice president for industrial relations for the BellSouth Corp. in Atlanta, GA, which is, as you know, one of the seven regional holding companies established as a result of the AT&T divestiture. I have been an employee of the Bell system for about 35 years, the last 15 of which I have been involved in personnel administration, either planning, negotiating, or administrating benefits for either Southern Bell, AT&T, or the BellSouth Corp.

BellSouth and its subsidiaries employ 97,000 people, of whom approximately 50 percent are female, and 19 percent are minorities. In addition, we have 25,000 retired employees who participate in most of our benefit plans. Seventy-one percent of our employees are covered by collective-bargaining agreements. Among our benefit plans are two qualified, defined benefit pension plans, two qualified thrift plans, a qualified section 401 thrift plan, self-funded and insured long-term disability plans, self-funded employer and employee paid medical care and dental plans, several nonqualified deferred compensation employee incentive plans.

All of our employees are eligible to participate in all of our qualified plans on the same basis, and all plan benefits are provided uniformly. In providing employee benefits to approximately 122,000 people, BellSouth benefits Planning and administrative costs amount to approximately $17.1 million annually, even though our administrative costs are minimized as much as possible because of our profit motive.

We would like to suggest several principles which we believe Congress should follow in designing tax incentives for employee benefits. First, tax incentives should be provided for benefits which Congress will be pressured to sponsor, if they are not sponsored by the employer. Second, tax incentives also should be provided for benefits which encourage productivity and the cost effective provision of employee benefits. For example, we heard several times this morning that tax incentives should be provided when employers retrain and relocate economically displaced employees. Third, tax incentives for employee benefits should not be subject to administratively complex and costly rules. Fourth, we believe that the most significant and potentially the most troublesome condition or restriction imposed on employee benefit tax incentives is the requirement that employers benefit plans satisfy regulations issued by the Internal Revenue Service. We would prefer that future employee benefit legislation not contain a broad realm of regulatory authority and that statutes passed by Congress contain all of the material terms and conditions affecting those incentives. Finally, BellSouth strongly endorses congressional efforts to assure that benefits are provided to all employees of an employer.

Tax incentives for employee benefits are not a wasteful Government expense, if structured according to the principles outlined above. As noted, our administrative expenses for our benefits programs are large, although we are as efficient in admistering our plans as possible. If we and other employers did not provide these benefits, Congress might be pressured to provide the benefits through federally sponsored programs, which in essence would entail your assumption of our administrative expenses. Also unlike the Federal Government, we are able to tailor our benefits as you have mentioned to the needs of our particular employees and to monitor wasteful overutilization of these benefits by the recipients and overcharging by the suppliers.

We appreciate the opportunity to express our views on these issues and welcome future opportunities to discuss specific programs.

Senator PACKWOOD. Thank you.

[Mr. Howard's prepared written statement follows:]

STATEMENT OF BELLSOUTH CORPORATION BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, HEARINGS OF THE SUBCOMMITTEE ON JULY 26 - JULY 30, 1984

Prepared by Mr. Roy B. Howard,
Mr. Clyde V. Manning, and
Randy L. New, Esq.

SUMMARY OF PRINCIPAL POINTS

I. The Type of Tax Incentives which Should be Provided.

A. Tax incentives should be provided to the employer for benefits which Congress will be pressured to sponsor if they are not sponsored by the employer.

B. Tax incentives should be provided for benefits which encourage productivity and the cost-effective provision of employee benefits should be fostered.

C. More distinctions should be drawn between large and small employers and between employers with union-represented employees and those without.

D. Specific incentives should not be subject to administratively complex and costly rules.

E. Employers should be encouraged to be fiscally responsible in providing employee benefits.

II. The level of Tax Incentives which Should be Provided.

Congress should provide incentives at a level to motivate employers to spend scarce corporate dollars on benefit programs.

III. Conditions or Restrictions which Should be Placed on Tax Incentives.

A. Abuse of tax incentives by the highly compensated business owner should be stopped.

B. Restrictions on advanced funding should not be imposed.

C. Favorable tax treatment should be conditioned on the establishment of a trust to hold benefit dollars.

D. No future employee benefits legislation should contain a broad grant of regulatory authority.

IV. The Effect of Existing Rules on Receipt of Benefits by all Employees.

BellSouth encourages Congressional efforts to assure that benefits are provided to all employees.

V. Cost Comparison among Employer Provided, Tax-Favored Benefits; Government Provided Benefits; Employer-Provided Benefits on a Taxable Basis; and Employee-Purchased Benefits.

A. The provision of employee benefits by the employer on a non-taxable basis maximizes the employee's selection of benefits over current cash compensation.

B. Any system of providing medical benefits or other employee benefits should incorporate co-insurance or some feature of employee choice and cost participation.

STATEMENT OF BELLSOUTH CORPORATION BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, HEARINGS OF THE SUBCOMMITTEE ON JULY 26 - JULY 30, 1984

BellSouth Corporation ("BellSouth") is vitally interested in the Subcommittee's general questions concerning federal tax law support of employee fringe benefit programs. We hope to provide you with the perspective of a large employer with a long history in employee benefits on the federal taxation of employee benefits and to recommend changes in the status quo so that the federal government's tax dollars "purchase" the largest possible amount of employee benefits. While we appreciate this opportunity to inform you of our general perceptions, we would appreciate additional opportunities in the future to communicate with Congress and Congressional staff members in a formal way when specific changes in the federal taxation of employee benefits are considered. We have attempted to answer the broad questions asked by the Subcommittee in its news release of June 4, 1984, albeit not necessarily in the order in which the questions were presented.

As you may know, BellSouth, a Georgia corporation, is one of the regional holding companies established as a result of the divestiture of American Telephone & Telegraph Corporation. Two of our subsidiaries, Southern Bell and South Central Bell, are corporations which provide local access telephone services to the American public in nine states: Georgia, Florida, Alabama, Mississippi, Tennessee, Kentucky, South Carolina, North Carolina and Louisiana. BellSouth and its eighty percent or more owned subsidiaries employ 97,000 people of whom approximately 50% are female and 19% are minorities. In addition, 25,000 retired employees participate in some or all of our employee benefit plans. Seventy-one percent of our employees are covered by collective bargaining agreements. We understand that we would be rated by Fortune 500 as the twelfth largest corporation in the United States were a rating based on assets. Our economic viability and employment opportunities are important throughout the southeast.

The Bell System, of which BellSouth used to be a part, historically encouraged employees to save for retirement. We have continued that tradition and appreciate federal tax incentives provided by Congress which have assisted our efforts. A variety of employee benefits are provided to employees of the BellSouth controlled group of corporations, although not all of our corporations' employees participate in all plans. Among our benefit plans are two qualified defined benefit pension plans, two qualified thrift plans, a new qualified Section 401(k) thrift plan which we have adopted on a limited basis, self-funded and insured medical benefit plans, self-funded short-term disability plans, self-funded and insured long-term disability plans, a self-funded vision care plan, self-funded and employee-paid dental care plans, and several nonqualified deferred compensation and employee incentive award plans. Union-eligible employees and the lowest paid two-thirds of all nonunion-eligible employees constitute 90% of our total employee population. All of our employees are eligible to participate in all of our plans on the same basis, and all plan benefits are provided uniformly. Obviously, the variety of employee benefits provided to employees and our "investment" in employee benefit programs which are affected by federal tax laws means that we are concerned with each question which the Subcommittee raised in its press release of June 4, 1984.

I. THE TYPE OF TAX INCENTIVES WHICH SHOULD BE PROVIDED.

We certainly believe that the tax law should continue to encourage employers to provide certain employee benefits. Several basic principles should be followed. First, tax incentives should be provided for those benefits which inherently will be provided by the federal government if they are not provided by the employer. These benefits include retirement, disability, medical and death-type benefits, the last of which the federal government would be called upon to replace by providing survivor's benefits. Tax incentives also should be provided for benefits which encourage the productivity of the American worker; for example, benefits which allow rank-and-file employees who have been economically displaced by mechanization to be retrained and which allow companies to relocate employees where they can be more productive and better compensated. In our opinion, Congress generally has encouraged these two types of employee benefits; however, the unwillingness of Congress in this session to exempt employee relocation programs from coverage under the new discount and interest-free loan provisions of the Deficit Reduction Act of

1984 and its unwillingness to extend the exclusion from employees' gross income of payments by employers under educational assistance programs illustrate that Congress perhaps could do more to consider the importance of employee benefit programs in encouraging productivity. We only relocate employees when we believe that productivity will be increased or that some other important corporate goal will be advanced; thus, tax incentives for our relocation benefits are not wasted on employee transfers which lack a real impact on our efforts to produce high-quality, low-cost telephone service. Similarly, the elimination of the educational assistance credit occurs at the same time that we are negotiating with the Communication Workers of America to assume a major portion of the burden for retraining employees and increasing their productivity.

The second principle we believe should be followed is that tax incentives should encourage the <u>cost-effective</u> provision of employee benefits. The cafeteria plan approach to employee benefits sanctioned by Internal Revenue Code ("Code") Section 125 is an example of cost-effectiveness; however, the recently-issued "use it or lose it" Treasury Regulations restrict the utility of cafeteria plans as we discuss below. Cafeteria plans are cost-effective in large part for the same reason that the Bell System's, and now BellSouth's, thrift plans are cost-effective, that is, they involve the employee in the purchases of benefits and make the employee a more educated consumer. Also, the administration of certain benefits are not cost-beneficial, and our employees' abilities to take advantage of some tax incentives are hampered by restrictions which we feel are unnecessary. For example, the deferral percentage test applicable to Code Section 401(k) plans adds unnecessary administrative expense to our defined contribution thrift plans which do not, and never will, discriminate because of the large plan participation by rank-and-file employees. The requirement that we amend our plans to include the top-heavy plan rules, despite the clear fact that our plans will never be top heavy, is another example.

The third principle which we would urge Congress to follow in designing and restructuring benefit tax incentives is that more distinctions should be drawn between large and small employers and between employers with union-represented employees and those without. The restriction that incentive stock option plans receive shareholder approval, a problem for large employers as discussed below, is one example. We also fail to understand why our funded welfare plans should be restricted as provided in the Deficit Reduction Act of 1984 since (1) the Act also imposes an excise tax on "disqualified benefits" to key employees, which we perceive to be the real problem, and (2) since the Senate bill contained an acceptable alternative proposal which taxed excess reserves in top-heavy welfare plans, a concept which could have reached those funded welfare plans used by small employers and professional corporations only as a device to defer more "owner" compensation. Unlike the owners of many professional corporations, neither BellSouth's owners nor BellSouth expects to receive the ultimate benefit of any moneys held in any welfare benefit fund, yet we face the administrative expense of

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interpreting and implementing this complex law and we face the inevitable cutback in funding certain benefits which the Act will cause. In contrast, the Code Section 416 top-heavy rules applicable to qualified retirement plans recognize the distinction between large and small employers and union and nonunion employers.

Large, publicly-owned employers such as BellSouth suffer from the perception that tax-favored benefit programs are often disguised shareholder dividends or tax shelters for the wealthy -- a perception which may or may not be true as to other types of employers. Perhaps this perception arises in part from a failure to understand the economics of employee benefits in a large, unionized employer. If BellSouth receives a credit or advanced deduction for providing an employee benefit, the tax savings really do not ever inure to the benefit of our shareholders. Before the credit or deduction is received, we have made an irrevocable commitment to spend a sum of money to provide a benefit to our employees. A credit never exceeds our cost in providing that benefit. An advanced deduction for a benefit to be provided in the future only compensates BellSouth for a real current loss of an equal amount of money since our unions and our status as a publicly-traded employer will prevent any money committed to a benefit from reverting to BellSouth or its shareholders. If a benefit is made taxable to the employee, in whole or in part, we generally will be pressured by our union and our employees <u>either</u> to "gross-up" the employee's salary or wage to neutralize the benefit's effect on his or her gross income <u>or</u> to eliminate the benefit. For example, we "gross-up" most of our payments to all of our employees for their relocation expenses (i) because most of their expenses will be in excess of the Code Section 217 dollar limits on deductibility of moving expense reimbursements and (ii) taxation of expenses in excess of those limits may block relocations and impair resultant productivity increases. In short, the economic and business pressures affecting our employee benefit plan choices are not the same as the pressures affecting other employers, least of all, professional corporations, and we ask for Congressional support in recognizing those differences in designing tax incentives for employee benefits.

The fourth principle which should be followed in providing tax incentives for employee benefits is that specific incentives should not be subject to administratively complex and costly rules. The complexity of administration and costs of compliance with the Section 401(k) discrimination tests have been discussed. As another example, the requirement that an incentive stock option plan receive shareholder approval presents problems in a large, publicly-held corporation such as ours where shareholders' meetings cannot be concerned with relatively minor corporate affairs. This particular requirement is anomalous since shareholder approval of other compensation programs, including other tax-favored compensation plans, generally is not required. Of course, the shareholder approval condition imposed on incentive stock option plans may be useful as a policy tool in the small corporation setting, especially in the case of professional corporations, where an increase in executive compensation occurs only at the expense of compensation for rank-and-file employees; however, no such economic principle applies in a corporation such as ours where the group that might receive an incentive stock option earns a miniscule percentage of total employee compensation, and the condition only contributes to our unwillingness to adopt an incentive stock option plan.

The fifth and last principle which Congress should follow in designing employee benefit tax incentives is that Congress should encourage employers to be fiscally responsible in providing employee benefits. Advanced funding of retirement benefits such as medical, death, and other benefits, and advanced funding of nonretirement benefits promotes fiscal responsibility by employers. Yet, a trend to decrease employers' abilities to fund benefits in advance is evident from the reduction in the Code Section 415 limits contained in the Tax Equity and Fiscal Responsibility Act of 1982 and the complex rules limiting advanced funding of welfare benefits contained in the Deficit Reduction Act of 1984. Advanced funding is a fiscally responsible action by BellSouth because current rate payers and not future generations of rate payers should pay the cost of employee benefits to current employees. Moreover, demographic trends of more retirees being supported by fewer working employees support advanced funding since advanced funding will offset the slow but steady increase in our liability for future employee benefits which occurs each year. Finally, a real danger of the welfare benefit plan funding limitations will appear when employers experience low-profit and no-profit years and, as a result, decrease those employee benefits which would have been unaffected had advanced funding been allowed to occur.

II. THE LEVEL OF TAX INCENTIVES WHICH SHOULD BE PROVIDED.

The five principles outlined above indicate the type of benefits which should receive tax incentives and the optimum design of those incentives. The Subcommitee also has asked what level of tax benefits is appropriate. We favor no significant limitation on the level of benefits which are tax-favored. Restricting the amount of a deduction for a particular benefit expense is not helpful in our case since our competitive environment and our obligation to negotiate with our unions determines in reality the total amount of compensation which we must pay to each employee. Our choices only are to pay current, deductible compensation, which does not save the federal government any future benefit expense or encourage changes which increase future productivity, or to "pay" deferred compensation or employee benefits which accomplish both of those goals. While tax credits, unlike deductions, are truly economically advantageous to BellSouth and should be limited to the amount necessary to persuade us to provide particular benefits, any restriction of existing tax credits for employee benefits or a refusal to increase them or create new ones where advisable decreases our incentive to provide employee benefits. Eliminating the existing exclusion from the gross income of an employee of any benefit creates pressure on BellSouth either to "gross-up" the employee's salary, thereby increasing telephone rates because of our heightened compensation expense, or to discontinue the benefit, thereby adversely affecting our employee relations and possibly our productivity.

In short, Congress should provide a level of credits, deductions, and exclusions for employee benefits which is adequate to offset the employers' costs in providing those benefits and to adequately motivate employers to spend scarce corporate dollars on benefit programs. We realize that credits, current deductions, and exclusions for employee benefits are perceived to have short-range, negative net revenue effect. However, increased reliance on employers to provide fringe benefits has at least two positive, offsetting effects. First, benefits can be delivered by employers more economically than by the federal government because (1) employers are in a better position to tailor benefit programs to specific employee needs, depending upon the ages, working conditions, socioeconomic status, and other characteristics of their employees, (2) the volume of business generated by a corporation of our size provides us with the purchasing power to buy benefits at the lowest possible cost, and (3) as the number of persons who belong to a particular benefit plan grows smaller, each person's benefit costs affect benefit prices to a great degree, and each person becomes more sensitive to the need to avoid wasteful overutilization. The latter reason for favoring employer-provided benefits is important since employees too often fail to discern the cause-effect relationship between overuse and abuse of federally-funded benefit programs and their individual tax liability. Second, if nothing else, providing tax incentives for employer-provided benefits saves the federal government the expense of administering federally-provided benefits. In providing employee benefits for approximately 122,000 people, BellSouth's benefit planning and administrative costs, excluding pension trust fund management costs, on an estimated annualized basis for 1984 equal $17.1 million. Our pension fund administration costs are $10.5 million. While these costs are significant, the benefit administration costs are less than 2% of the total costs of benefits delivered to participants, and our treasurer's administration costs are less than .2% of the value of the trust fund. Of course, our administrative costs are minimized as much as possible because of our profit motive, and the federal government's experience in providing replacement benefits probably would not be as favorable.

We regret our inability to inform you of the specific tax incentive level which will produce a particular benefit program from BellSouth. As noted, we welcome the opportunity to comment on specific reform proposals at a later date. Obviously, consideration has been given to tax incentive levels in choosing and bargaining the benefit programs which BellSouth maintains and which were previously listed; however, you should only conclude from our willingness to maintain those plans that federal tax incentives are marginally sufficient. While we have no plans to abandon any existing benefit plan, assuming present tax incentives levels and rules are maintained, BellSouth's plan choices are and will be sensitive to changes in federal tax incentives. As a final comment on the level of tax incentives, if Congress is truly concerned with assuring that rank-and-file and disadvantaged employees benefit significantly from tax-favored employee benefits programs, then restricting either our ability to deduct currently employee medical benefits or the employee's ability to exclude medical benefits will be counterproductive. This is true because an employee's medical costs as a percentage of total compensation are higher as the employee's total compensation decreases, thus, lower paid employees currently benefit disproportionately from our tax-favored medical benefit plans.

III. CONDITIONS OR RESTRICTIONS WHICH SHOULD BE PLACED ON TAX INCENTIVES?

While the need to minimize administrative costs and nonfunctional conditions in designing federal tax incentives for employee benefits has been discussed generally, BellSouth favors certain specific statutory restrictions and conditions and opposes others. BellSouth supports efforts to curtail abuse of tax incentives by the highly compensated business owner; for example, we always are amenable to the restriction that benefits must be provided as a uniform percentage of pay since we generally are more favorable to lower-paid employees. If antidiscrimination rules are clearly elucidated in the statute and reasonable, we support them as well. BellSouth opposes any restrictions on advanced funding because they prevent future benefit costs savings and hamper prudent management of future costs, as discussed before. Conditioning favorable tax treatment on establishment of a trust to hold benefit dollars is acceptable, although BellSouth's need to manage trusts in a conservative manner because of its position as a publicly regulated utility causes problems when we are forced to interpret the extremely vague prohibited transaction rules.

BellSouth strongly supports tightening of the rules concerning the Pension Benefit Guaranty Corporation. Specifically, federal insurance premiums should be risk-rated such that employers who fund their plan above the minimum funding standard pay lower premiums. Plan funding and plan termination rules should be upgraded to minimize the risks that employers, such as BellSouth, will indirectly absorb other employers' pension liabilities.

Finally, the most significant "condition" or "restriction" which often is imposed on employee benefit tax incentives is the requirement that the employer's benefit plan satisfy regulations issued by the Internal Revenue Service. Increasingly in the future, when Congress designs a tax incentive package for a particular benefit that includes the prospective issuance of "clarifying" Treasury Regulations, we feel Congress will discover little or no employer interest in providing the benefit until and unless broadly based, final regulations are issued. The proposed regulations interpreting Code Section 125 cafeteria plans have been a lesson to employers. As you know, many employers have used cafeteria plans to effectuate health care cost savings and deliver a cost-effective benefit to their employees, as we previously discussed. We planned to adopt such a plan but awaited the issuance of regulations. Now, with the Internal Revenue Service's insistence on the "use it or lose it" approach in cafeteria plans, the value of these plans to us and to employers who have used them in the past is minimized. Not only were the proposed regulations delayed for an inordinate amount of time after enactment of Section 125, the Internal Revenue Service first indicated <u>retroactive</u> disqualification of zero-based reimbursement accounts which were arguably within the vague language of the statute. BellSouth's legal counsel recently drafted a cafeteria plan which strictly conforms to the proposed regulations and, <u>as a result</u>, met only a part of our needs. Moreover, despite scrupulous adherence to available authority, our counsel is unable to opine that the plan avoids the constructive receipt doctrine which Code Section 125 statutorily waives.

As further evidence of the effect of this de facto condition, many employers of whom we are aware have Section 401(k) plans which allow for in-service distributions to employees upon hardship. Yet, we still do not have benefit of the Service's official interpretation of the scope of the hardship exception to the prohibition against in-service distributions from Section 401(k) plans, and, needless to say, we will not make any hardship distributions in the interim. Almost every employee benefit provision of the recently-enacted Deficit Reduction Act of 1984 with which we are concerned contains the ubiquitous Treasury Regulations proviso. We would prefer that future employee benefits legislation not contain a broad grant of regulatory authority and that statutes passed by Congress contain all the material terms and conditions affecting those incentives.

IV. THE EFFECT OF EXISTING RULES ON RECEIPT OF BENEFITS BY ALL EMPLOYEES.

BellSouth does not oppose any Congressional efforts to assure that benefits are provided to all employees of an employer, whether through rules such as the minimum participation and vesting rules which apply to qualified retirement plans or through simple, mathematical antidiscrimination rules. However, we do object to discrimination rules such as the Code Section 125 rules which are more complex than meaningful in guaranteeing benefits to rank-and-file employees. For example, if BellSouth provides all employees with an equal opportunity to select among a cafeteria plan's permissable benefits, why should we be required to insure nondiscriminatory selection of benefits by employees? We can only insure such a selection by examining cafeteria plan elections which already have been made during a plan year and by making unfair, retroactive adjustments.

While supporting the current Congressional attempt to assure provision of benefits to rank-and-file employees, BellSouth questions the advisability of the decrease in the Code Section 415 dollar amount limits and the postponement of the cost-of-living adjustment in those limits both contained in the Tax Equity and Fiscal Responsibility Act of 1982. Since the total amount of compensation and benefits which we must pay to our top executives due to marketplace pressures remains constant, notwithstanding tax law changes, the dollar amount and cost-of-living changes have forced BellSouth to increase its use of nonqualified deferred compensation plans for executives.

V. COST COMPARISON AMONG EMPLOYER-PROVIDED, TAX-FAVORED BENEFITS; GOVERNMENT-PROVIDED BENEFITS; EMPLOYER-PROVIDED BENEFITS ON A TAXABLE BASIS; AND EMPLOYEE-PURCHASED BENEFITS.

Although no statistical data is available in our records by which we can compare the selection of employee benefits by a broad cross section of our employees if the benefits are alternatively (i) government-provided, (ii) employer-provided on a nontaxable basis, (iii) employer-provided on a taxable basis, or (iv) employee-provided, our general experience with our employees in designing and administering employee benefit plans is that the provision of employee benefits by the employer on a nontaxable basis maximizes our employees' selection of employee benefits over current cash compensation. For example, as a logical proposition, more employees will elect immediate cash compensation instead of "planning" for medical expenses through participation in a comprehensive medical expense benefit plan if tax savings are not involved <u>and</u> the employer pays little or none of the cost of the benefit directly. Moreover, the less income that the employee receives during the year, the more likely he or she is to ignore the advantage of participation in a good medical insurance or medical benefit program. Thus, a shift to an employee-purchased medical benefit system or a system in which the employer provides medical benefits on a taxable basis would result in less participation, especially by lower-paid employees. Concomitantly, as the number of benefit plan participants decreases, the price of medical coverage for each remaining participant increases because only persons significantly at risk select coverage. Additional government-provided medical benefits, the last alternate, seems an unwise policy choice given the problems which plague the existing Social Security system and the Medicare and Medicaid systems.

Notwithstanding the foregoing, any system of providing medical benefits or other employee benefits should incorporate co-insurance or some feature of employee choice and cost participation in order to minimize overutilization and to demonstrate to the employee the relationship between his or her individual benefit cost and the price of purchasing the benefit in the future. We already have explained that removal of the tax incentives currently provided to our employee benefit programs will merely result in increased costs to us and, therefore, to increased telephone bills since we will be unable, for business reasons, to decrease significantly the benefits which we provide to the employee on a tax neutral basis.

VI. SUMMARY.

As stated, we appreciate the opportunity to express our views to the Subcommittee on the tax incentives which should be provided to employers who provide employee benefit programs and to employees who participate therein. If you have specific proposals or questions, we, again, would appreciate the opportunity to express our views.

Senator PACKWOOD. Let me ask each of you to respond to one question. How important is this issue to the very top level management? Let me preface it by saying this: I understand when an issue comes along and it affects an industry and they lobby it heavily. In addition to their company lobbyists and trade association lobbyists, they will retain some of the very good private lobbyists in this town—the Charlie Walkers, the Bill Diefenderfers, the Timmons, and Corrologuses—that type of group. I saw it on syndication, involving whether or not the television networks or the movie industry was going to keep the money from syndication rights. I saw it on the tax bill in 1981 when we were talking about 10-5-3. The 10-year depreciation on property, and 5 years on personal—and 3 years on cars. Whenever it is really important to the business, the presidents and the chief executive officers come here and call us up and hire all of the lobbyists that are available beyond their normal lobbyists. That has not happened on this issue, nor does it happen with the trade associations—the NAM, the Chamber of Commerce—do not take the strong position on this. Is that because this issue isn't quite of sufficient importance to the corporations that they will devote the lobbying resources to it that they will to other issues? I will start with Mr. Howard, and then just go across.

Mr. HOWARD. We are sort of a new kid on the block in this issue, and I think our particular corporation misjudged what would happen. We really felt that the lobbying effort that was going on—conducted by many groups—would be effective. We somewhat lent our efforts to those groups, thinking they were going to carry the ball, but I can assure you that the top management of our company is seriously concerned about this for two reasons. First of all, we are concerned about the productivity and morale of our employees, all 97,000 of them, because they have to be productive. Employee benefits are very important in that issue. And the other one is that it hits us in the pocketbook. So, we know in dealing with the union, if this becomes tax, then we are going to have pressure by the union to gross up to offset that tax. So, for those two reasons, it is a very important issue. We will do a better job from here on.

Senator PACKWOOD. I might say that the unions have used their very top people on this. To them, this is one of their two or three highest priorities and they lobby this to the full extent of the pressure they can bring. I did not quite find that true with this issue. Mr. Biggins.

Mr. BIGGINS. LTV has been expending extensive resources on lobbying employee benefits, and particularly cafeteria plan benefits and benefit banks, but it has been mostly done internally, which is true of even other lobbying efforts. We have a fine staff in Washington, and they have been working very hard over the last year or so on this subject, and it is very important to LTV and it is important to the chairman of the board of LTV, and he has been personally in contact with Senator Bentsen in Texas, and it is something of considerable concern to us.

Senator PACKWOOD. I don't want to give you a misimpression. Both the Association of Private Pension and Welfare Plans and the Society of Benefit Administrators lobbied this well, and they are good organizations. For some reason, business just did not bring the pressure and clout on this for whatever reason they bring to other issues. The impression that leaves in the minds of the Members of Congress is that this issue isn't quite that important to them.

Mr. BIGGINS. I think it is an organization problem. I think it is a matter of the APPWP and ECFC and the other organizations—Washington Business Group on Health—who are involved in lobbying, getting us a particular effort together on this, and I wouldn't be surprised if that might not happen because it does require a special effort. And a lot of the people in those organizations tend to be specialists as opposed to lobbyists, and they need to go the next step, I think, and actually retain the kind of lobbyists that you are talking about.

Senator PACKWOOD. Mr. Winters?

Mr. WINTERS. I think in the case of the life insurance industry—certainly in the case of the Prudential—there are a couple of forces. I would start by saying that these issues are very important to us. There is not an awful lot of technology in the life insurance business. It is a people business, and it is vital to us that we be able to use resources wisely, effectively, to hire, retain, and motivate our employees because that is the success of the organization.

I think the reason you have not seen—a couple of the reasons at least that you have not seen—us vigorously on this subject are, first—as you are well aware—in the Deficit Reduction Act, we had our own income taxation very much at issue, and we worked that. Second, the employee benefit issue really has only recently developed any sharp point. There has been a gradual erosion of the commitment to stability, to predictability, to at least implicitly agreed upon policy for employee benefits. I think we were rather rudely awakened when the IRS issued the tentative regulations on benefit banks and flexible savings plans. We were in the process of developing a cafeteria plan. We wanted to use it as a vehicle, as Mr. Biggins described, to introduce more cost-containment measures in our plan and also to extend the plan to some benefits which had not previously been included. We have not yet figured out any way to make that step forward without the appeal to the employees of a benefit bank or something like it. I was interested in the third alternative which Mr. Biggins put forward, and I want to pursue it some more. But I think that perhaps the biggest single factor has been the lack of any sharp point on the issue from the viewpoint of employers.

Senator PACKWOOD. Could it be this? For whatever reason—and I have got my own theories but I can't prove them—but things looked easy for a while. For example, when Jack Curran of the labors union came to me with the issue of prepaid legal. He said we will take care of it. We went through the energy crisis, and we added van pooling. We added educational assistance, and all of these by and large had administration support in those days. Whether it was the Ford administration or even a couple of them in the late Nixon administration, or the Carter administration, and it looked like it would not end. If it was something that was generally regarded as philosophically good for the broad mass of employees, we would encourage it. I began to see in the last 2 or 3 years a change in that philosophy. What you are saying is that business may have been more or less blindsided—they didn't see this change coming.

Mr. WINTERS. The word blindsided suggests that somebody took advantage of us. If we missed it, I think it is our own fault. I must say I was very disappointed to hear Secretary Chapoton report what seemed to be such a strong consensus on the part of the administration that benefit banks are bad, they cost revenue, and they do not serve to contain costs. I am not aware that there is anywhere near enough evidence yet to demonstrate that, in effect, as you will see---

Senator PACKWOOD. But the evidence is the other way.

Mr. WINTERS. Yes.

Senator PACKWOOD. By and large, apart from the whole philosophical concept that these ought to be taxed. The only examples that are ever used are the very specific examples of the small corporations devising plans to take care of their officers and twisting the Tax Code to their advantage. That we can take care of. That isn't hard to take care of with the nondiscrimination rules, and every one of your businesses and 99 percent of the other businesses support those kinds of rules. We have no problem with that. When you heard Mr. Chapoton talk today, you were hearing a philosophical objection. Several times during the debate on this issue, he freely admitted that even if we took care of all of the specific abuses that would not change the administration's position.

Mr. BIGGINS. I think one indication of their approach to this is that they refer to reality—actual cases—as anecdotal, which is kind of, I guess, an academic way of putting something down. But they really failed. They close their eyes to the actual experience that is available to them. They ask for it and, in fact, it is being given to them, but I don't think they really look at it.

Senator PACKWOOD. That is very common to our way of thinking. We are much more inclined toward inductive rather than deductive reasoning. You take a specific and you reason to a conclusion. You know, Three Mile Island has a problem and that is what is wrong with the nuclear industry. Well, that isn't what is wrong. Or, four nuns get murdered in El Salvador. Now, despite the fact that at least the alleged culprits have been caught and sentenced, we say that is what is wrong with El Salvador. Well, that isn't the only problem that exists. There was a fascinating article about 2 months ago. It was on the 30th anniversary of the battle of Dien Phien Phu, interviewing both of the generals who are still alive—General DeCastrase in France and General Gap in Vietnam, as to their view of the battle. The French, 14,000 of them, were encamped on the valley in Dien Phien Phu, hills all around them. General DeCastrase indicated we weren't worried about the hillsides because we knew there was no way to get there—there were no roads. General Gap's view was, when I saw the French were going to stay on the floor of the valley, I thought to myself how can we get artillery to the hillsides. For anybody who has traveled through Asia and seen their extraordinary use of manpower, it was clearly not beyond their thinking to disassemble every one of those pieces of artillery and haul them up and down trails and reassemble them on the mountainsides. When you saw the map of the final battle, the French were just surrounded with artillery on all sides. After a long bombardment, they had to surrender. What I discover is that we are faced with people who are going to use specific examples, and say that is what is wrong with benefit plans.

I suppose no matter what kind of curative legislation we pass, somebody is going to figure out some loopholes to abuse it. We have never drafted perfect statutes yet, and unless we have a broad-based lobbying effort, the evidence that you have all laid down today of the thousands of employees covered on a nondiscriminatory basis, is the kind of evidence that we need. I have that evidence. Few others have it, but it has got to be lobbied at the very highest level to bring that point home, and especially more on the Ways and Means Committee. Between the battle, we won it here and lost it in the Ways and Means Committee. Nothing will make a greater impression on a Member of Congress than the president or CEO of a corporation headquartered in that district employing lots of people in that district. Calling up the member on that committee and saying, listen, let me tell you how this affects your constituents. Mr. Hankins, I didn't even let you talk. I apologize.

Mr. HANKINS. I am sure this is a very important issue to us and to our management. We have uniform benefits all the way throughout the company, from the president on down. So, there is a selfish as well as a managerial concern. I don't think that we are probably staffed and postured to do as much lobbying as perhaps we should. We have a very small corporate office, and I think it is probably my fault that the president hasn't been more concerned about this. He has got an awful lot of things to be concerned about in general, and I am the director of employee benefits, and I should be in there firing him up on this.

Senator PACKWOOD. I will make you a bet. I don't think this is going to happen, but, if Vice President Mondale gets elected and one of his tax programs was a 5-percent increase in the corporate income tax, every major CEO in this country would contact every one of us on the Finance and Ways and Means Committees in opposition to that.

Mr. HANKINS. You are absolutely right. We will see what we can do.

Senator PACKWOOD. Thank you. I would appreciate it. Gentlemen, thank you very much.

Mr. BIGGINS. Thank you, Senator.

Senator PACKWOOD. We will conclude today with a panel consisting of David Hurd, the senior vice president from Bankers Life in Des Moines; Philip Briggs, the executive vice president of Metropolitan Life Insurance; Allan Press, trustee of the National Association of Life Underwriters; and Mary Nell Lehnhard, the vice president of Blue Cross and Blue Shield.

Mr. Hurd, good to see you again.

STATEMENT OF G. DAVID HURD, SENIOR VICE PRESIDENT, THE BANKERS LIFE, DES MOINES, IA, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE HEALTH INSURANCE ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. HURD. Thank you very much, Senator. It is good to see you again. Both Phil Briggs and I are here today to jointly represent the life and health insurance business, and we are hoping to have brought with us some simple eloquence on the part of the workers of the United States, who think that the tax incentives have built the private benefits system and we compliment the Congress for maintaining them through the decades. We have built a public private partnership, and it is aimed in my mind at income replacement. When a worker retires, gets disabled, dies and leaves dependents, with catastrophic medical costs, these programs are aimed at replacing that income and neither Government nor the private sector can do the job alone.

As an indication of the private sector's success, there are about 162 million people under age 65—workers and dependents—who have medical coverage, employer sponsored. And in the pension area, when we get a little bit past the turn of the century, about 71 percent of the people retiring at that time will have employer-sponsored pensions. What is the message behind the data—we are trying to emphasize as has been said earlier this morning—it is not just the high-paid folks that are covered—it is the rank and file workers.

We will certainly concede that there is more to be done—that there are coverage gaps when you have got an issue such as long-term care for the fragile elderly—that is going to be a very difficult thing. But we feel that we have so concentrated in the last few years on the part of the glass that is empty and we haven't looked at the part that is full, and we think that we have talked so much about the blemishes in the tapestry of employee benefits that we haven't really taken into view the whole tapestry and looked at what it has accomplished. The very concept of tax expenditures, that there is this very large tax expenditure of benefits, we think is evidence itself that the programs are broad and deep and are not confined to a relatively few high paid persons. And also that if we do in some major way try to unwind the tax structure around it—we cut the employee benefits themselves. These are needs that are being met for the workers and consequently there will be pressure on the Government to expand the Medicare Programs, Social Security, medicaid, whatever, and the revenue gain is to a degree a loser. You commented earlier this morning and we certainly strongly feel that a stable tax law is necessary. Why? Plan sponsors are looking across decades—I was in a conversation yesterday in our office, talking about our benefits program, and we were talking about retiree life insurance for people who haven't been hired yet. You can't do that kind of planning in an environment where there is an annual fruit basket upset on what the rules are. It forces employers to a short-range view. In closing, I would like to comment that the pension system has built $1 trillion of assets that are used to finance American business. In a sense, it makes ordinary people capitalists because they become owners of capital in the form of their pension rights, and in 1983, I was amazed to find that almost a fifth of the total funds supplied in U.S. credit and capital markets came from the pension system. As recently as 1978, it was only an eighth—it is a growing supplier of that commodity.

With that I will close and turn it over to Phil.

Senator PACKWOOD. Mr. Briggs?

[Mr. Hurd's prepared written statement follows:]

Statement

of the

AMERICAN COUNCIL OF LIFE INSURANCE
and the
HEALTH INSURANCE ASSOCIATION OF AMERICA

on

EMPLOYEE BENEFITS

Presented by

G. David Hurd, Senior Vice President
The Bankers Life
and
Philip Briggs, Executive Vice President
Metropolitan Life Insurance Company

Before the

Senate Committee on Finance
Subcommittee on Taxation and Debt Management

July 26, 1984

I am G. David Hurd, Senior Vice President of The Bankers Life, Des Moines, Iowa. With me today is Philip Briggs, Executive Vice President of the Metropolitan Life Insurance Company in New York. We are appearing here today on behalf of the American Council of Life Insurance and the Health Insurance Association of America. The Council has a membership of 611 life insurance companies which, in the aggregate, have 95 percent of the life insurance in force in the United States and hold 99 percent of the assets of insured pension plans. The HIAA has 320 members which write over 85 percent of the commercial accident and health insurance in the United States. Most of the members of the Council are also in the business of accident and health insurance.

We are pleased that your distinguished Subcommittee is holding this public hearing on employee benefits because it affords us an opportunity to document the vitally important role employee benefits play in providing economic security to hundreds of millions of American workers, their beneficiaries and retirees. In recent years, Congress seems to have lost sight of this fact. It has enacted major legislation affecting employee benefits on an ad hoc basis and as a tool to increase revenue in the short run, without fully considering the long-term implications of such legislation.

Too often, such legislation has been formulated and finalized in "eleventh hour" sessions without adequate discussion or representation from plan sponsors, service providers and regulatory agencies. We must adopt a national policy statement on how we want private employee benefits to impact our lives and those of our children. This hearing is certainly a step in the right direction.

While this hearing focuses on employee benefits, we believe it is important that Congress, as it seeks to reduce the deficit, examine all tax incentives and federal spending programs, not just those associated with employee benefits. Only after Congress has reviewed the cost, value, and the distribution of benefits among the population of all tax incentives and federal programs, is it possible to discuss any changes in the tax status of employee benefit arrangements.

GENERAL COMMENTS

A short time back as history counts time--no more than three-quarters of a century ago--the average working person could...

- o Become ill, forfeit his pay for the period of his illness, spend his meager savings in the pro ess of recovering, and none but his family would care.

- o Become disabled, lose his earning power, sink with his family into poverty--and no one but his kin would be concerned.
- o Grow old without savings to support him, lose his place to younger, stronger workers and retire in penury.
- o Die early in life with nought for his surviving family.

Historians persist in calling this era of domestic concord and international amity "La Belle Epoque"--the beautiful time. Yet in the everyone-for-himself pursuit of industrial progress, the arrangements for dealing with the vicissitudes that might befall the average working person were individual, largely voluntary and very much uncertain. Henry Steele Commager summed up the social attitude of the day, as embodied in the stories schoolchildren read in their McGuffey Readers: "Have faith. Should ill befall you, some kind person will provide."

Today, thanks to both the persistence of Congress in building a system of social support and the forbearance of Congress in encouraging the private sector to join in this effort, working people no longer need to depend upon the magical appearance of "some kind person" when ill befalls them. In the 73 years since the first employer bought for his employees the first group insurance policy, this country has developed a system of social support that is certain, manifold, unique and--as subsequent testimony will show--robust, adaptable and growing more extensive with each passing year.

Today the typical working person can look at the evils that might befall him and know that employer-sponsored benefits will:

- o Pay health bills when he is ill,
- o Provide income during periods of both short and long-term disability,
- o Provide a solid foundation of life insurance benefits, and
- o Produce in retirement years an income generally proportional to his work life earnings.

As testimony today will demonstrate, private enterprise has built an effective and efficient arrangement covering the needs of employees through employer-sponsored pension and welfare plans. It benefits the majority of rank and file workers and their dependents and is far superior to any government program which could replace it. It should not be modified in the name of greater tax revenues. Employee needs are there and must be met, and if private enterprise is not encouraged to meet those needs, government will inevitably be pressured into doing the job. We believe the ultimate price to our nation would be greater.

To be sure, there are blemishes in the tapestry of employer-sponsored pension and welfare plans which will need attention in the years ahead. But, in recent years, Congress has placed too much emphasis on tax revenue in drafting legislation that affects pension and welfare plans. Congress needs first to study the security these programs deliver to America's workers--in every income bracket and in every state--and then try to develop a national policy before legislating further.

So, today we want to focus attention on the part of the glass that is full, rather than on the part that is empty. These employer-sponsored programs are of major importance to the rank and file workers of America. The programs have a simple goal. Coupled with government programs, the objective of employer-sponsored programs is to replace wages lost through retirement, death or disability, and to protect against a significant portion of catastrophic medical costs.

How broadly has this goal been met? The response of the private sector has greatly reduced the need for government funded social programs. The health insurance programs of U.S. businesses today cover about 162 million persons under age 65 through some form of private group health protection. This private effort has very much reduced the demands on government for a national health insurance program and its accompanying need for increased taxes. The pension programs of U.S. businesses are maturing: by the time individuals age 35-44 in 1979 retire, 71% can expect to receive a pension benefit. The growth in private pensions substantially reduces pressure on the Social Security system to increase benefits and, therefore, to increase Social Security taxes.

The Congress has been wise for decades in legislating, through the tax laws, encouragement to American business to create and maintain these programs for workers' security. As a result, the United States now has a partnership between government programs and employer-sponsored programs that delivers income security to most workers against the major hazards of life. In the years ahead, your task will be to legislate to maintain and improve this public/private partnership. Congress should continue to provide maximum encouragement, through the tax laws, for the vigorous growth and expansion of employer-sponsored pension and welfare programs. The "tax expenditure" is large because these programs are and will be providing income security to most workers. Programs providing benefits across the spectrum of the work force do not come cheap.

As part of the effort to establish a national policy on employer-sponsored pension and welfare programs, we ask the Congress to think long and hard on one fundamental. These programs are, by their nature, long-range programs. The goal is to provide lifetime financial security for workers. To plan and carry out programs that run for decades, employers need stability in government policy and rules. Lately, the Congress has been changing the rules for these programs in virtually every session. This creates an unstable environment full of uncertainty which forces employers to think almost entirely in the short range. To preserve and strengthen the structure of employer-sponsored programs, Congress should retreat from this counterproductive annual revision of rules for pension and welfare programs, and focus instead on the long view. We understand the forces that have pushed for an annual tinkering, but these must be resisted for the long-term welfare of American workers and their families.

EMPLOYEE PENSIONS

Social Security, employer-sponsored retirement plans and individual savings, together, have traditionally been used to provide retirement income security for American workers and their families. It is important that there be a proper balance among the three mechanisms. In this regard, the function of the Social Security system is to provide only a basic floor of income protection for retired and disabled workers and for the survivors of deceased workers.

There are two basic reasons why the private system for providing retirement benefits should be voluntary. First, it is consistent with the market orientation of our society. Even if the terms of a pension agreement are not bargained in union negotiations, an employer has good reason to cast his pension plan in a form most valued by his own employees: plans are too expensive for an employer to provide unwanted benefits. Moreover, government has minimum flexibility when administering programs for everyone, but private decisions provide flexibility and minimize political problems. Through the private employer-sponsored pension system, workers and employers can easily adjust to changing views about retirement age and other retirement issues. The other basic reason is that retirement provided through Social Security does not generate a supply of capital as do private savings arrangements.

These two reasons - more individualized choice and more private capital - provide strong arguments for placing heavy reliance on the private pension system for retirement income protection. There is an additional consideration: the tax benefit given to pension plans only postpones the tax on savings. In the current academic debate about tax policy, there is a considerable school of experts who say the right way to tax all savings is to postpone tax until the income is consumed and that current taxation of savings results in double taxation.1/

Future Retirement Benefits under Employer Retirement Plans

Private pension plans currently make a substantial contribution to meeting retirement needs of American workers. In 1979, more than 74% of full-time, full-year workers participated in an employer pension plan.2/ Moreover, a significant percentage of all workers are employed by firms with pension plans so that non-participating workers have the potential to participate in a plan and receive pension benefits.

Despite these impressive statistics, trends in pension coverage and participation have recently been the subject of criticism and the perception in Congress that pension coverage is

1/ On this adacemic discussion, see What Should be Taxed-- Income Expenditure? Jos. Pechman ed. Brookings, 1980.

2/ Schieber & George, Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement (Washington, D.C., Employee Benefit Research Institute, 1981) not wide-spread. In our view, however, these discussions of pension coverage often miss several important points about the structure of employer retirement programs and their relation to retirement income. Two important questions which must be recognized are: (1) what percentage of families will receive private pension benefits upon retirement? and (2) what will be the size of the average pension benefit?

Since 1980, the Council commissioned ICF Inc., a Washington, D.C. consulting firm, to undertake two studies of these important questions. In October 1982, ACLI published a report on ICF's findings entitled, Pension Coverage and Expected Retirement Benefits.

The study completed in 1982 concluded that the role of pensions could be expected to expand substantially in the future as the pension system matured. The study showed a dramatic increase over the 25-year period from 1979 to 2004 in the proportion of families age 65 to 69 drawing an employer-sponsored pension.

This study was based on detailed information about the U.S. work force, collected by the Census Bureau, and a careful projection of how workers would gain or lose pension coverage as they aged. The evidence of the study was that in each year over the next 25, more retiring workers will have spent much of their working lives under the broad coverage and faster vesting pension rules in place after the enactment of ERISA. The increased proportion of retirees getting pension benefits does not involve any assumption of pension growth; only a projection of conditions actually revealed by the Census study in 1979. The study found that private pension and Social Security benefits alone could be expected to replace over 75 percent of after-tax pre-retirement income in the initial year of retirement for over one-half of all families.

In part because the results of the Council study challenged many preconceived notions about the role of employer pensions, the study's methodology and results were scrutinized carefully. For example, in late 1982, the House Select Committee on Aging asked the Congressional Research Service (CRS) to examine the study's results and its methodology. This review culminated in a report prepared in July 1983 by the CRS for the House Committee on Aging. Other formal and informal critiques of the study were also prepared.

The CRS review was, on the whole, complimentary to the ICF study but, as did other reviewers, suggested that the results might change if various key assumptions were changed. To respond to the major questions which had been raised, ACLI contracted with ICF in 1983 to conduct additional research on expected retirement income receipt.

The major findings of the 1984 study have just been published and confirm the findings from the 1982 study that benefit receipt under private pension plans will increase sharply and that the average pension will increase faster than wages:

The percentage of families receiving pension benefits will increase rapidly in the future. The percentage of families expected to receive employer pension benefits is increasing rapidly. The study shows that by the time those individuals age 35-44 in 1979 reach age 67, approximately 82 percent of all married couples and 58 percent of unmarried individuals can expect to be receiving employer pension benefits from at least one spouse's covered employment. Table 1 below shows that benefit receipt at age 67 for the group age 35-44 in 1979 will be 25 percent higher than benefit receipt for the group age 45-54 in 1979. Even these estimates understate the potential levels of benefit receipt because about 10-15 percent of individuals who will still be working at age 67 and are nonetheless eligible for pension benefits are not counted as receiving benefits.

Due primarily to the increase in the labor force participation rates of women and the maturing of the pension system, Table 1 also shows that married couples have a substantial likelihood that at least one family member will receive a pension benefit. In addition, unmarried individuals have a substantial likelihood that they will receive either pension benefits from their own prior employment, or survivor benefits from a former spouse's employment.

TABLE 1

EXPECTED AVERAGE FAMILY PENSION BENEFITS
AT AGE 67
(in 1983 dollars)

	Cohort Age 45-54 in 1979		Cohort Age 35-44 in 1979	
	Percent Receiving Benefits	Average Pension Benefits	Percent Receiving Benefits	Average Pension Benefits
Married Couples	70%	$8,200	82%	$10,400
Unmarried Individuals	44%	$5,500	58%	$ 7,400
All Families	57%	$7,200	71%	$ 9,300

SOURCE: ICF estimates. This table does not include benefits from IRAs. It understates the percentage of families eligible for pension receipt because individuals working at age 67 who have a vested right to a pension benefit are not counted as receiving benefits.

Pension benefit levels will also increase. Table 1 shows that the average family pension benefit at age 67 will increase to approximately $9,300 per year (in 1983 dollars) for those individuals age 35-44 in 1979. This is an increase of almost 30 percent as compared to the average family pension benefit at age

67 for those individuals age 45-54 in 1979. The built-in assumption of wage growth over time means that the age 35-44 group would have real wages 16 percent higher at retirement than the age 45-54 group. The remaining 14 points of the 30 percent increase reflect the continuing maturation of the pension system. Specifically, workers aged 35-44 in 1979 will have worked under expanded employer pension programs and under supplemental retirement plans and ERISA's vesting rules for 10 more years than workers aged 45-54 in 1979.

Pension benefit levels will be significant at all income levels. The study shows that among individuals age 35-44 in 1979, average pension benefits at age 67 will be slightly larger than average Social Security Benefits. Thus, the average annual pension for this group will be about $9,300 (in 1983 dollars) while Social Security will be only $8,700 (in 1983 dollars).

Pension and Social Security Benefits combined will replace 70 percent of pre-retirement income. The study calculated the expected replacement rates for families which were not working in retirement. As expected, replacement rates from Social Security and employer pensions will be higher for low income workers. Social Security and pension benefits will replace an average of over 100 percent of pre-retirement income in the initial year of retirement for families who earned an average of less than $10,000 per year (in 1983 dollars) in their highest five years of income after age 56. Replacement rates fall below 60 percent for income groups above $20,000. The study also estimates that over 70 percent of those families with an average of less than $10,000 in pre-retirement earnings will receive retirement benefits that replace over 80 percent of their income. On the other hand, less than one-quarter of those with over $15,000 in pre-retirement income will have replacement rates larger than 80 percent.

Pension benefits will be widely distributed. While a significant number of families can expect to receive income from private pension plans, the distribution of average pension benefits differs among family categories. For families with individuals age 35-44 in 1979, more than 60 percent of married couples and almost 40 percent of unmarried individuals can expect to receive annual pension benefits above $2,500 (in 1983 dollars). Over 35 percent of married couples and 18 percent of unmarried individuals can expect to receive annual pension benefits above $7,500 (in 1983 dollars).

Pension Funds in U.S. Capital Markets

Retirement savings are an important source of long-term investment in the capital goods so essential for a growing and dynamic economy. The general importance of pension funds in capital markets is suggested by the data in Appendix 1. At the end of 1983, total assets of private pension plans and state and local retirement plans amounted to nearly $1 trillion. From 1980 to 1983, the total grew at about a 15 percent annual rate (which includes the effect of stock market and other capital gains).

Private pension plans and state and local retirement plans are providing a growing part of the funds supplied to U.S. credit and capital markets. In Appendix 2, flows of pension funds to U.S. credit and capital markets are shown by major type for recent years. In 1983, these pension funds supplied about $101 billion, or 19 percent of the total funds raised in U.S. credit and capital markets. Five years earlier, 1978, these pension plans provided 12.5 percent of the total funds raised in these markets.

The assets of non-insured private plans generally are more concentrated in corporate equities and U.S. government securities than are the funds of "insured" pension plans (Appendix 3). About one fourth of the pension funds administered by life insurance companies are now held in separate accounts. The assets in these accounts are largely in corporate bonds and corporate equities, but with a growing amount in mortgages and real estate (see Appendix 4). The remaining three fourths of these funds, handled through general accounts of life companies, are invested primarily in corporate bonds and commercial mortgages.

EMPLOYEE GROUP LIFE INSURANCE

The purpose served by group life insurance is to replace the income lost through the occurence of an employee's untimely death. By promising such replacement, group life insurance also serves to improve the morale and productivity of employees by relieving them of significant anxieties and risks resulting from death. Employer-sponsored benefit plans are the best way of accomplishing this purpose. Corporate-sponsored employee benefit plans are now an integral part of the attitudes and philosophy of our economic way of life.

The initiative for group life insurance has primarily come from corporate management, spurred on by insurance companies who recognized the need for employee protection and who formulated the instruments for serving that need. In slightly less than three-quarters of a century, the concept of protecting a wage earner against the physical hazards that threaten his or her paycheck has become an accepted part of private industry's thinking. The tremendous growth of group life insurance programs, not only in the number of workers insured, but also in the variety of coverages available, is a heartening illustration of what the private sector can accomplish in the way of economic security for the wage earner.

The quest for economic security will not diminish in intensity; rather it can be expected to increase. The solution lies in the hands of private enterprise. That is, small, as well as large employers, must be encouraged to continue to accept the social responsibility of adequately protecting their employees against the loss of income through untimely death or disability.

Since its beginning in 1911, employee group life insurance has enjoyed wide public support. In the editorial column of the Saturday Evening Post of October 4, 1913, appeared the following observation: "No married man who has not a fortune has any business to be without it [life insurance]. We should like to see this group-risk plan elaborated until life insurance and paycheck go together". When the Union Pacific Railroad established its plan in 1917, one well-known religious figure was quoted, "The system is the practical putting into effect of the principles of Christian charity. It establishes the most friendly relations in the minds of all and brings about harmony and sympathy."

The attitude of the individual worker has also generally been favorable to group life insurance plans. The files of insurance companies are full of grateful acknowledgements from widows and widowers who had no finances other than group life insurance proceeds to help them over the difficult period of readjustment following the deaths of their spouses. By opening the channels of insurance to all industrial workers, regardless of age, sex, physical condition, or character of employment, group life insurance has performed an outstanding service.

The growth of group life insurance has been prodigious since its introduction in 1911. At the end of 1983, group life insurance in force through employers was $1.7 trillion and more than one-half million employers of all sizes had purchased life insurance for their employees. In a 1983 survey conducted among medium and large employers by the U.S. Department of Labor, 96 percent of all employees were reported to be covered by group life insurance. And, while the numbers are not quite as dramatic, a 1983 survey conducted by the Life Insurance Marketing and Research Association (LIMRA) among employers of 3-50 employees indicated that more than 80% had purchased a group life insurance policy as part of a package of employee benefits. Group life insurance is a near-universal employee benefit in the United States.

The amounts of life insurance provided through employer-sponsored plans is typically related to the individual employee's salary. According to a recent survey conducted by Hewitt Associates among major U.S. employers, in 1983 approximately 73 percent of all such employers had purchased group life insurance schedules that were salary-related, with the most popular salary multiples being 1-times (32% of the employers) and 2-times (22% of the employers). In a survey conducted by the Council in April, 1981, more than 50 percent of the total claim payments made under group life insurance policies were in amounts exceeding $25,000 per beneficiary.

Employer-provided group life insurance also reflects the changing nature of the American work force. It is well-known that increasing percentages of women are entering employment. According to a recent Council publication, nearly 52 percent of all married women were in the workforce in 1982, up from 41 percent in 1971. A Council study of trends in death benefit payments under group life insurance policies indicated that in April, 1981 almost 20 percent of the deaths were female employees, representing a significant increase over the 13 percent reported in October, 1966.

In recent years, the attractiveness of group life insurance has led an increasing number of employers to extend such insurance beyond the working years of their employees. In a survey conducted by The Conference Board in 1979, more than two-thirds of a sample of large and small employers indicated that they were continuing some group life insurance protection into retirement. A later survey conducted in 1983 by Hewitt Associates indicated that among large employers the percentage exceeded 80 percent.

And, as a growing number of states change their restrictive group insurance laws, employers are extending their group life insurance plans to include spouses and dependent children. Where now permitted, the aforementioned Conference Board survey indicated that 25 percent of large and small employers were providing some dependent group life insurance.

As shown by these statistics, employer-provided group life insurance has grown rapidly in the 73 years since it first became available. There are broad social aspects to the growth of group life insurance. One great service of group insurance is that it extends life insurance coverage to a large number of persons with little or no other life insurance. And, group life insurance also extends protection to persons who cannot qualify for individual life insurance either because of physical problems or hazardous occupations. The proportion of employed persons who are uninsurable for individual policies has been variously estimated between 5 and 10 percent. It is only through group underwriting that private life insurance can provide protection for these persons, and it is advantageous both to the individual and to society that insurance be made available to them.

EMPLOYEE GROUP HEALTH INSURANCE

Group health insurance is of enormous value to the public and our industry has been highly successful in meeting the needs of American workers. Federal tax incentives played a major role in that achievement. They continue to be an essential element in the present system for the protection of employees and their families.

The health insurance provided under employee benefit plans falls into two broad categories. The first is represented by benefits for hospital, physician, dental and other medical expenses. A great variety of coverages is available from many companies active in the market, in response to strong consumer demand. We estimate that at the end of 1982, almost 65 million workers had group health coverage. Including spouses and children, approximately 162 million persons under age 65 were covered by one or more forms of private group health protection, either through our member companies or through other arrangements. That represents 80% of the under 65 civilian non-institutionalized population, and is a five fold increase since the end of World War II. Although more remains to be done in expanding the number covered, we are proud that much has been accomplished.

The second category of health insurance represents income payments to disabled workers for either short or long-term benefit periods. In 1982, almost 62 million workers had short-term protection under various private arrangements, of whom 27 million were covered under insurance company group plans. Most commonly, employees' short-term coverage lasts 26 weeks and income benefits usually equal two-thirds of salary. Many employees are covered for long-term disability, with benefit periods of five years or to age 65. At the end of 1982, 17 million persons were covered under group plans for long-term disability. Carriers have continuously explored every opportunity to further extend disability income coverage to employees, and to ensure that adequate benefit levels and payment durations are available.

The questions posed by the Subcommittee relate to tax incentives to employers to encourage health benefits for their employees. The tax incentive to the employer is the deduction allowed for the cost of the benefits. The employer cost is not taxable income to employees, although disabled employees are subject to tax on income benefits in whole or in part. Thoughtful issues have been raised, which should lead to a productive discussion of the subject.

In our view, tax incentives can be justified if desirable public objectives are achieved through the appropriate response of private enterprise. For many years there have been tax incentives to encourage employers to provide health benefits to employees. We believe that a major public objective has been achieved in that 162 million persons--workers and their families--have one or more forms of group health insurance protection. Secondly, that achievement has been accomplished by private enterprise, which, through competition in a free economy, has delivered its product to the best advantage of the consumer. We believe the wisdom of granting the tax incentives has been well proven for the following reasons.

The Protection of the Public. Over the past several years, most Americans have come to recognize that medical expense insurance is a basic necessity. Today it is indeed reckless to risk financial devastation on account of accident or sickness. Adequate group health coverage eliminates a major source of fear and uncertainty for those who are covered, both rich and poor alike. Group medical expense benefits are the same for both high and low income employees, and provide access to health care services that might otherwise be unaffordable. The existence of Medicare and Medicaid demonstrates government's commitment to coverage for those for whom public programs are necessary. It is the private sector that has met that same need for the bulk of the population through employee health benefit plans.

The ability of private companies to offer group insurance goes hand in hand with the tax incentives for employers and employees. The relationship can be explained by a brief description of how group insurance is underwritten.

Under current industry practice, medical expense and disability income benefits can be made effective for an employee group without individual medical evidence of insurability, if at least ten employees are involved. The usual rules only require that the employees enroll when first eligible, and that they be actively at work when coverage is to become effective. Dependents are also covered on a non-medical basis under similar rules. This liberal approach to offering coverage is of enormous importance to the public, since many persons become group insured who would have difficulty obtaining medically underwritten individual insurance.

Insurance companies can appropriately price group health insurance and maintain acceptable financial experience, despite the absence of individual evidence of insurability. The reason is that a high degree of employee participation in the plan is required. If the plan is contributory, at least 75% of employees must enroll, and all employees must be covered under non-contributory plans. With these participation requirements, a reasonable cross section of risks is obtained which provides stability to the financial experience. These rules ensure that both young and old employees enroll, and also the healthy as well as those who have medical problems.

There is usually no difficulty in getting employees to enroll, since the value of health coverage is appreciated and the employer pays all or nearly all of the cost of the plan. Furthermore, the employer contribution is not taxable income to the employee. There is a supportive relationship between tax incentives which encourage employers and employees to participate in group health benefit plans, and the ability of insurers to successfully underwrite such coverage without medical evidence of insurability. This has worked so well that the protection of 162 million Americans under 65 has been accomplished by the private sector without any need for federal intervention.

Response of the Private Sector. As noted above, a justifiable tax incentive policy should accomplish desirable public objectives through the appropriate involvement of private enterprise. The protection of the working public through employee health benefits has been accomplished by private enterprise in a very effective manner. We believe that our industry has developed group health insurance in the best traditions of a free economy, further confirming that tax incentive policy was the right approach for government. Today, the group insurance market place is served by hundreds of insurers, offering extensive portfolios of health benefit plans to fit a variety of circumstances and employer pocketbooks.

It was insurance company innovation that brought high limit major medical expense coverage to the market. That form of insurance, introduced nationally in 1951, covers a wide range of medical services provided both within and outside the hospital, and was designed to encourage use of out-of-hospital services. It is by far the most prevalent form of medical insurance today, with over 90% of those protected by group plans having major medical coverage. A 1980 study showed that for employees with major medical protection provided by insurance companies, about three-fourths had a maximum benefit of $250,000 or more. Nearly half had a maximum benefit of $1 million or an unlimited amount. Insurance company innovation also brought to the market dental expense and vision care insurance, as well as benefits designed specifically to contain the acceleration in health care costs. Illustrations of such benefits include coverage for skilled nursing facilities, home health care services, pre-admission testing, second opinions for surgery, ambulatory surgery facilities, preventive care, hospice care and drug and alcohol rehabilitation.

The pluralistic nature of the private health insurance business has resulted in intense competition among carriers. As a result, an insurer must keep its premiums as low as possible which provides both employees and employers with the most cost effective protection possible. The consumer interest is also protected through our system of state insurance regulation, covering such areas as group policy and certificate provisions, group conversions, and so forth. In fact, due to the flexible nature of the business, employees may continue to maintain medical expense protection upon termination of employment by either converting to an individual policy or continuing benefits under the group plan for various periods. In many instances, coverage is also continued for a specified time for dependents who lose eligibility due to an employee's death or divorce.

A particularly relevant example of how the competitive insurance market place served the public interest was the development of group insurance for small employers with as few as one or two employees. According to Department of Commerce data, there were 4.3 million firms with one to forty-nine employees in 1980. These small groups probably provide employment for over 15 million workers. To serve that market, insurers developed pooling techniques and simplified underwriting rules and, as a result, small employers today have a wide choice of plans. The stimulus of tax incentives and the willingness of carriers to voluntarily enter the small group market have been of great benefit to small employers and their employees and families. As a result, small firms can today obtain many coverages once only available to large groups, and can fully realize the advantages of the tax incentives in the law.

Overall, the encouragement of health insurance coverage through tax incentives has been enormously successful in terms of social and economic accomplishments. The present system of employment related health benefits was built up over several decades, and works very well. Americans have come to regard employer-sponsored health protection almost as an automatic feature of employment, providing benefits of great value. In our view, no change should be made in tax incentives which might impair the ability of the private sector to provide essential insurance protection to the public.

The Subcommittee has asked whether the existing tax incentives are effective in protecting the working public at a lower total cost than alternative mechanisms or arrangements. The implication is that under such alternatives, there would either be cutbacks in or the elimination of the present tax incentives.

Let us consider one alternative based upon the supposition that all employer contributions to health benefit plans would be taxable income to employees, either immediately or on a phase-in basis. Our industry stands on record in firm opposition to such taxes because of the many flaws in that approach. At this time however, we shall confine our discussion to how such a change could affect the ability of insurers to offer insurance products and the likely cost to consumers.

A fair allocation of employer contributions to each employee for tax purposes would be a very complex task. Whatever formula was used, the total cost of group health insurance would be increased by the amount of tax raised. The cost to a particular employee to participate in the group plan would become the employee's contribution plus his tax on the allocated employer contribution. For many employees, the cost to participate would increase sharply, causing both the discontinuance of coverage and the weakening of the group insurance mechanism through adverse selection. This may be seen as follows:

In the first instance, low income employees, especially those that live in our major urban areas, would be particularly hard hit by the tax. In our highest cost cities, annual premiums for small group family coverage can be $4,000 to $5,000 in the middle age ranges, and higher at older ages. While imputed income would be the same for high and low income employees, the tax impact on the low wage earner would be much more severe in terms of affordability. It is likely that low income employees without health problems would be pressed to drop their group health coverage. That could mean disastrous consequences for such families upon subsequent illness, and government might have to eventually shoulder an increased burden under public programs.

There are other employees that might decide to withdraw from group coverage in addition to low income workers. Examples are young healthy employees that can secure individual coverage at a lower cost than the group employee contribution plus income tax. When employees have incentives to either go without group insurance, or purchase individual coverage, the group plan is exposed to adverse selection through low participation. A good cross section of health risks is more difficult to maintain. As a result, the average health status of the insured group is poorer and premiums must rise, which causes more employees to drop out. The resulting spiral of higher premiums and increased withdrawals can threaten the financial viability of group plans, especially in the small group range.

The opening of the door to adverse selection could seriously undermine the group insurance mechanism through which millions have been protected on a non-medical basis. Overall, the removal of the present tax-free status of employer contributions could easily result in a drop in the number of people protected, especially low income employees in high cost cities. Furthermore, more adverse selection would occur, impairing the financial stability of many group plans and the ability of carriers to underwrite liberally. That indeed would be a heavy price to pay for any additional tax revenues raised.

Such deterioration of the present system would certainly result in renewed political pressure for national health insurance. We estimate that in 1983 the cost of private group medical expense coverage was in the range of $105 to $110 billion, with financing and benefits determined by market place conditions, involving carriers, employers, and unions. With a government operated plan, Congress would face the difficult task of raising new taxes each year equal to or greatly in excess of these amounts. In view of the financing problems now posed by Medicare, Congress would be ill advised to embark upon such a vast public program.

In our view, any alternative to the present system must be subjected to searching analysis to determine just what improvements are possible. We know what the private sector has been able to accomplish with the stimulus of tax incentives. We are deeply skeptical that major changes can be made to generate new revenue without weakening the present employer health benefits structure that has worked so well.

CONCLUSION

As our testimony today has shown, the private sector has accomplished a great deal in providing socially valuable benefits to American workers and their families. The job, however, is not done--there are still gaps in coverage. The private sector is anxious to close these gaps, but it needs help. Tax incentives have worked in the past, but they must be continued and, where appropriate, expanded, to provide the impetus necessary to complete the job.

We appreciate the opportunity to appear before you today to express our views on this very important subject. If you have any questions we would be happy to answer them.

Appendix 1

Pension Plan Reserves in the United States
(Amounts in billions)

	Total*	Pension reserves of life insurance companies	
		Amount	Percent of total
1970	$211.9	$ 41.2	19.4%
1975	323.8	71.7	22.1
1980	650.7	165.8	25.5
1983	993.6	264.6	26.6
Average annual compound rate of increase:			
1970-1980	11.9%	14.9%	
1980-1983	15.2	16.9	

*Includes reserves and assets of pension plans administered by life insurance companies, other private pension plans, and state and local government retirement plans.

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, and American Council of Life Insurance.

Appendix 2

Private Pension Plans as a Source of Funds in U.S. Credit and Capital Markets (Amounts in billions)

		Funds supplied by					
		Pension plans with life insurance companies		Other private pension plans		State & local government retirement plans	
Year	Total funds supplied	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total
1978	$390.2	$18.3	4.7%	$16.0	4.1%	$14.3	3.7%
1979	400.1	17.5	4.4	16.0	4.0	19.4	4.8
1980	374.1	20.6	5.5	20.3	5.4	23.4	6.3
1981	377.6	28.6	7.6	21.1	5.6	24.3	6.4
1982	397.0	32.7	8.2	26.5	6.7	26.8	6.8
1983p	527.2	37.9	7.2	31.7	6.0	31.5	6.0

p - Preliminary.

Source: Bankers Trust Company, Credit and Capital Markets 1984, and Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

Appendix 3

Uses of Funds by Private Noninsured Pension Funds
(Billions)

	1978	1980	1982	1983 est.
Corporate bonds	$ 7.4	$ 3.1	$ 3.5	$ 3.6
U.S. Government and agency securities	-0.1	4.5	10.2	8.4
Corporate stocks	5.3	9.6	11.5	18.0
Mortgages	2.5	1.8	1.3	1.5
Other	0.9	1.3	-	2.0
Total	$16.0	$20.3	$26.5	$31.7

Source: Bankers Trust Company, Credit and Capital Markets 1984.

Appendix 4

Distribution of Assets Held in Separate Accounts
of Life Insurance Companies*

	1970	1975	1980	1982	1983
			(Millions)		
Bonds	$ 878	$ 2,553	$ 12,392	$ 24,563	$ 27,294
Stocks	4,041	9,323	17,705	20,641	25,118
Mortgages	37	200	687	2,556	4,372
Real Estate	2	563	3,341	5,686	6,437
Other	103	334	1,647	3,835	4,635
Total	$ 5,061	$12,973	$ 35,772	$ 57,281	$ 67,856
Memo: Total pension reserves of life insurance companies (billions)	$ 41.2	$ 71.7	$ 165.8	$ 225.2	$ 264.6

*Assets in separate accounts are valued at market or, in the case of real estate, appraised market value.

Source: American Council of Life Insurance.

STATEMENT OF PHILIP BRIGGS, EXECUTIVE VICE PRESIDENT, METROPOLITAN LIFE INSURANCE CO. OF NEW YORK, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE HEALTH INSURANCE ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. BRIGGS. Thank you, Mr. Chairman. I am Philip Briggs, executive vice president of Metropolitan, and representing the ACLI and the HIAA. My comments today have to do with the simplicity and effectiveness of the group mechanism and the fact that it has worked so well for so many employees and their dependents over so many years. The reason it worked so well is because it has a very clearly favorable tax situation. Without that tax situation, the system just would not work. Perhaps I should spend a minute to explain that, since sometimes something that one thinks obvious is not obvious after all.

Group coverage includes virtually everyone in the group. The reason you do include everyone in the group is because the employers contribute a large part of the cost of the policies and he deducts it on a tax-favored basis to the employees. If that tax favored situation did not exist, the plans would not work. Employees would drop out. And the people who would drop out the soonest are probably the people who need it the most. The people who are on the low end of the income scale and, of course, the people who are young and healthy, will take the chance of not being covered. As a result, you end up having a price spiral on the cost of the plan for those who stay in which makes it impossible for the plan to continue. That is a major danger which I see. Admittedly, if a tax change was made, we would not destroy the system overnight. It would take some years, probably, but I am sure as I am sitting here that if all these benefits are taxable, you will see gradually, over a period of years, a complete erosion of a system which has served this country extremely well for over 40 years, a system which is unique to America. No other country has similar plans.

I think the other aspect which we probably should consider is the question of abuses.

I think you mentioned yourself, Senator, a few minutes ago, that we tend to hear about the abuses. We have been trying to correct those abuses. We unfortunately sometimes kill the favorable factors which also exist at the same time. We overkill in trying to correct perceived abuses. I think we should address abuses directly. I agree with you—the system can be fixed. I just hope we do nothing to destroy what has been an extremely favorable system for the American worker. Thank you.

Senator PACKWOOD. Thank you. Mr. Press?

STATEMENT OF ALAN PRESS, TRUSTEE, THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, DEMAREST, NJ

Mr. PRESS. Thank you. Mr. Chairman, committee members. I am Alan Press. I live in New Jersey and work in New York City. I am a trustee of the National Association of Life Underwriters. With me is Danea Kehoe Martin, an NALU attorney.

My business is like the business of the 130,000 professional life and health insurance agents whom NALU represents. We sell and service life insurance and health insurance, frequently as part of employee benefit plans that we design for small businesses.

President Reagan calls America a shining city on the hill. Governor Cuomo has expressed a fear that instead America is a tale of two cities, with the other city populated by excluded misfortunates living in the shadow of the glittering city above.

We believe that Government decisions—like tax-favored employee benefit plans and welfare programs like medicaid and food stamps—create an America that comes closer to the President's one shining city than it does to the tale of two cities with its bottom layer of neglected poor.

As a society, America has demanded that we, through our Government, guarantee a certain basic level of risk-resistant economic security. Tax-favored employee benefits are a key part of that guarantee. This is because the many forms of employer-provided life, health, retirement, and disability insurance protection keep literally millions of Americans off welfare rolls. Welfare, in its many forms, is the ultimate insurer of the American guarantee of a basic level of risk-resistant economic security. NALU responds to your six specific questions in our prepared statement. Here we will focus on just one, whether discrimination rules assure that all employees share in tax-subsidized fringe benefits.

Fringe benefit law must achieve a balance between encouraging employers to provide fringe benefits and assuring that all workers share in those benefits. On one hand, the tax incentive must motivate employers to spend what is a substantial amount, even on a before-tax basis. This means that the employer must benefit. This benefit comes from the benefit package's ability to attract quality personnel, and because the employer's decision makers are also employees who will participate in the fringe benefit package.

On the other hand, because we taxpayers subsidize tax-favored fringe benefits, we rightly demand that they be available to all employees, at least in basic amounts and varieties. The appropriate balance then lies in the flexibility that discrimination rules allow.

If discrimination rules permit employees to reward the productive, if they demand equal availability but still allow an employee to opt out without lessening or preventing the benefits' availability to those who do want them, they will be appropriately structured and balanced.

Thus, the popular 25 percent test is too rigid. To require that no more than 25 percent of all benefits can go to key employees discriminates against small business—and 79 percent of all of our country's businesses employ fewer than 15 people. Thus, a decision to opt out by one or two or three of only 10 or 12 employees will reduce the total amount of benefits that can be offered.

Big businesses with large work forces can absorb the nonparticipant without butting up against the 25 percent test. But small employers cannot. Thus a 25 percent test gives a competitive advantage to big business when it is small business that is spurring economic growth and creating new jobs.

We urge you to draft discrimination rules that achieve a balance between employer incentives to provide fringe benefits and universal availability of fringe benefits to all employees. Indeed, if we could afford it, we should be offering tax-favored fringe benefits for the self-employed, too . . . and raising inflation-eroded limits like the $50,000 ceiling on tax-free group life insurance. Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you. Ms. Lehnhard?

[Mr. Press' prepared written statement follows:]

NALU The National Association of Life Underwriters
1922 F STREET, N.W., WASHINGTON, D.C. 20006-4387 • 202 / 331-6000

STATEMENT OF

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

ON

TAX TREATMENT OF EMPLOYEE FRINGE BENEFITS

TO THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

UNITED STATES SENATE

JULY 26, 1984

Mr. Chairman and members of the subcommittee, The National Association of Life Underwriters represents those whose business involves the sale and service of life and health insurance, especially under the umbrella of employee benefit plans. Thus, our clients are usually employers, especially small employers, and their employees.

NALU is a federation of more than 1,000 state and local life underwriter associations which together represent almost 130,000 career life and health insurance salespeople.

First, on behalf of both NALU and our clients, thank you for scheduling these hearings and allowing us the opportunity to testify. The debate that begins here will certainly result in a fuller understanding of the fringe benefits issue, because of your wisdom in shaping the discussion to include social policy implications. NALU congratulates you for this step toward halting the unfortunate trend of changing, limiting or eliminating important tax provisions without fully considering relevant factors other than the tax revenues that underlie our tax code provisions. We are confident that after this debate on both the justification for and cost of fringe benefits, Congress will select wisely among the many existing and potential proposals to fashion equitable, cost-efficient fringe benefit legislation. We stand ready to assist you in this vital task.

In announcing this hearing, Mr. Chairman, you posed six basic questions to which we will respond. First, however, let us indulge in a generalized overview, set in a context of metaphor created by the opposing sides of this 1984 election campaign.

<u>Fringe Benefits Support Healthy, Prosperous Society</u>

President Reagan has characterized America as a "shining city on a hill." New York Governor Mario Cuomo responded that America is a "tale of two cities," one glittering on the hill but the other enveloped in darkness, excluded from the fruits of the labor of those enjoying economic prosperity.

In reality, the truth probably lies somewhere in the middle. Our government, on behalf of those governed, strives mightily and continually to achieve the necessary balance between supporting the productive effort of our free economy and assuring that the benefits of that free, productive economy are shared fairly among all those whose labor contributes to it. Much of this governmental effort is successful. One example of this success is the tax treatment of employee fringe benefits. Appropriately structured employee fringe benefit laws assure that we all share in the comfort and security created by a prosperous economy. Further, employee fringe benefit tax laws accomplish this sharing in an effective, cost-efficient manner.

The key words in this generalized overview are "appropriately structured" fringe benefit tax laws, and "necessary balance" between supporting a productive economy and assuring a fair distribution of that economy's benefits. Also important are the concepts of "effectiveness" and "cost efficiency." Accordingly, let us discuss that which makes fringe benefit tax law "balanced," "appropriately structured," "effective" and "cost-efficient."

In general, a balanced, appropriate structure requires tax laws that encourage an employer to provide employees with benefits that assure "risk-resistant economic security." These benefits must be available to all employees, but at a cost that makes economic sense to both the employer and to the Federal treasury, the provider of the tax subsidy. To be cost-efficient, the cost of providing the tax subsidy must be less than the cost of providing the benefit directly. To be effective, the cost must be commensurate with the benefit obtained by the entity--employer or taxpayers--incurring the cost.

Risk-Resistant Economic Security

What benefits contribute to "risk-resistant economic security?" Health insurance protects against financial devastation due to illness or injury. Life insurance promises to replace income lost due to premature death of a breadwinner. Child care assistance allows an employee to take advantage of an opportunity to perform productive work. Pension benefits safeguard old age, when the ability to work is reduced or eliminated. Disability insurance assures continued income in the event of long-term illness or injury. Pre-paid legal benefits bring beneficiaries a step closer to guaranteed justice while permitting individuals to take advantage of such protective measures as will preparation or legal counsel prior to taking an action that may have legal consequences. There are other benefits that are variations or enhancers of these basic benefits. For example, 401(k) savings plans strengthen pension protection. Dental and/or vision insurance supplements basic health insurance.

In addition, there are varying forms of these benefits. Health insurance can be provided through the usual major medical and/or hospitalization policy, or through an employer-sponsored medical reimbursement plan. Pension benefits can come from defined benefit, defined contribution or profit-sharing plans, or through annuities. Employees may select the benefits most useful to them through use of flexible spending cafeteria plans.

The list of basic benefits and their variations in form is long, and it would be counter-productive for NALU to try to list here each benefit, in each form in which it is available. Rather, our most useful contribution to your examination into the best possible balanced, appropriately structured, effective, cost-efficient fringe benefit law will be advice, based on our collective experience in selling and servicing life and health insurance benefit plans, on the effect of employee benefits and benefit structures on the literally millions of Americans we serve.

Should Tax Law Encourage Employer-Provided Fringe Benefits?

Yes. Risk-resistant economic security demands that most people be covered by a minimum level of some form of life, health and retirement "insurance." That "insurance" can be traditional, contractual protection as embodied in a typical life or health insurance policy, pension plan or annuity contract. Or it can be one of the new, more flexible and sometimes more cost-effective mechanisms such as self-insured medical reimbursement plans or cafeteria plans. Or, it can be government-financed and administered social programs, such as Social Security, Medicare, Medicaid or food stamps.

To forego that minimum level of risk-resistant security means that we, as a society, would decide to let some people starve, or die for lack of adequate health care. In short, to refuse to assure that minimum level of risk-resistant security would be to accept the "tale of two cities," with the excluded unfortunates subsisting in the darkness of the shadow cast by the glittering city above.

There will be little if any controversy in rejecting such a division of "have's" and "have not's." Most, if not all, American citizens accept their societal responsibility to be sure that as many people as possible enjoy a standard of living that at the very least precludes starvation or illness caused by lack of money.

Once we accept that we as a society want--indeed, demand--that basic level of protection for all, the next issue becomes how to achieve it in the most comprehensive yet cost-efficient manner. Tax-encouraged employer-provided fringe benefits are proven, efficient means of doing so.

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It is almost axiomatic that the private sector can accomplish any economic goal more efficiently than can government. Yet, the cost of providing employee benefits is substantial. For example, nationally, 36.7% of payroll is expended on employee benefits. Thus, employers, motivated at least as much by profits as by a desire to "do right," generally require an economic incentive to spend the money to provide employee benefits.

Of course, the need to attract and retain competent employees is such an incentive. But it is not enough, nor will it ever be enough while there are more people seeking work than there are available jobs.

The ability to provide employees with tax-free (or tax-favored) benefits is a strong incentive. Keep in mind that "employers" are also employees. The people deciding to install an employee benefit plan are at least equal beneficiaries of it. Thus, the tax incentive appeals to the employer/employee's self interest as powerfully as it appeals to the desire to "do right" by the work force. The facts prove that the tax incentive of fringe benefit law works. It has motivated employers to fashion what is becoming an increasingly strong and important "economic safety net."

For example, employer-provided life insurance is a near-universal employee benefit. In 1982, 94% of all group life insurance was provided through an employer. Group health insurance was provided to 66.37% of all nonagricultural wage and salary workers in 1983. Almost 93% of those employees earning less than $30,000 annually participated in a group health insurance plan. Some 59% of all nonagricultural wage and salary workers were covered by a private pension plan in 1983.

<u>What Type and Level of Incentive Is Appropriate?</u>

Current law does a reasonably good job of identifying the basic benefits necessary for "risk-resistant security." To the extent that the benefits (e.g., health insurance) can be provided income tax free, the level of incentive is also appropriate. Competitive, free-market factors serve as an adequate control of over-use or provision of these benefits. In fact, although fringes (not all of them tax-free) accounted for 27% of total compensation in 1980, they accounted for only 28.5% in 1983. This 1.5% growth rate over three years is far lower than the rate of growth experienced betwen 1950 and 1980 (15.6%). And, a substantial portion of the growth rate is attributable to the increase in Social Security taxes paid by employers on behalf of their employees, increased (taxable) vacation time, etc. Thus, it appears that the portion of compensation going for tax-free fringes is at or near stabilization.

Another example of free-market control is employer-provided health insurance. Consider the frightening annual increases in health care costs, and, as a result, health insurance. Private sector efforts to curb these costs--through deductibles, coinsurance, flexible spending cafeteria plans that include medical reimbursement accounts, wellness programs, upgraded and increased consumer education, increased sharing of premium costs, etc.--have finally halted the spiralling increases. This year's figures show a drop from 15% to 9% in the health care cost inflation rate.

Indeed, there are very good arguments for increasing the level of tax-subsidized fringe benefits. For example, the limit of $50,000 in tax-free life insurance benefits has been eroded by inflation in the 20 years since Section 79 was enacted. Those who are self-employed are, in fairness, just as entitled to share in these tax preferences. Further, there is no policy justification for limiting tax-favored fringe benefit provisions to employees.

However, we realize that you don't need and won't welcome proposals and justifications for increasing government's cost of assuring our socially required minimum level of risk-resistant security. And although it is painful to admit to what amounts to punishment of those among us who are motivated, competent and productive, the fact remains that self-employed people are typically not the drain on societal resources that some of our population are.

<u>What Conditions/Restrictions on Tax-Favored Fringe Benefits Are Appropriate?</u>

The most important restriction on fringe benefit law should be a careful identification of which benefits go into the basic bundle of protections that are required for risk-resistant security. Certainly, life insurance, health insurance and retirement insurance--in all of their many forms--are vital protections. Other benefits may well be appropriate elements of the security package, too.

Next, the law should in general restrict tax-subsidized provision of employee benefits to situations in which all employees have an equal opportunity to participate. Indeed, there are perhaps some benefits that should be required, if any at all are to be offered, at at least a minimum level. For example, because we the taxpayers will pay the cost of uninsured catastrophic illness, it is sensible to require a basic level of health insurance protection before any other benefit could be provided on a tax-favored basis. However, it would be costly waste to mandate duplicated protection. Thus, where a potential beneficiary earns enough to disqualify him or her from Medicaid coverage, or where both spouses work and have access to employer-provided coverage, the mandatory basic level of protection needed to qualify for the tax benefit should be waived or enforced only once per family.

Appropriate rules to insure that all employees have an equal opportunity to receive the basic bundle of security-assuring benefits should include a relatively short--e.g., one year for life insurance, three months for health insurance--maximum waiting period before employees are eligible to receive benefits. Vesting after a reasonable period of service is necessary. But, Congress must remember that minimum and maximum waiting periods, vesting schedules and other eligibility requirements will necessarily vary among the different benefits.

Are Existing Fringe Benefit Rules Sufficient To Prevent Discrimination?

No. The rules are not uniform in concept or design, and in many cases they discriminate against small business. Discrimination rules, where they are necessary, should be as uniform as possible, but care must be exercised to avoid applying "rules of thumb" where such would be inappropriate for a specific benefit.

The first step in fashioning an optimum discrimination rule is to identify those benefits which should be mandatory for all employees (assuming that any benefits are to be offered). Discrimination rules here are, of course, not required, because all employees would have to be eligible. Next, those benefits which all employees should have the option of selecting must be identified. Then, benefits of value to and appropriate for long-term productive employees should be identified. Discrimination rules for these selective employee benefits should be written.

For example, basic levels of life and health insurance should be mandatory benefits, if benefits are to be provided at all. The employer's choice of providing extra levels of these benefits should be contingent on the benefits' equal availability to all employees. Life insurance coverage levels should be pegged to compensation levels, but health insurance will be utilized, if at all, by employees in all income classes without regard to compensation level. For example, a mailroom clerk's appendectomy will cost the same as the company president's, assuming comparable physical conditions, doctors, hospitals, and complications.

On the other hand, pension benefits are appropriately keyed to length of service and income level. Here, the appropriate discrimination rule should consider equal percentages of pension compared to salary history and equally applied additions to percentage limits to take advantage of length of service. Thrift plans, such as 401(k) profit-sharing plans, are more in the nature of rewards for faithful or valuable service and as such should be subject to discrimination rules that have sufficient flexibility to allow employers to reward long-term employees without having to carry new-hires at an equivalent level. At the same time, the benefits should be provided regardless of the level of the employees' earning capacity. Perhaps the required vesting schedule would provide the necessary flexibility.

Finally, Congress must remain aware that what is an invaluable benefit to Person A may be totally useless to Person B. A child care assistance program for the widowed janitor who has two primary-grade children will be a boon that surely qualifies as among the appropriate benefits to be included in the bundle of risk-resistant security protections. However, the 60-year-old childless accounting clerk will derive no benefit at all from the program. To require an employer to contribute to the program on behalf of both of these employees would completely waste the contribution for the accounting clerk (or, put another way, double the cost of providing the benefit to the janitor). Thus, while both should have an equal chance to benefit from the program, the employee who doesn't want it should be able to opt out without imperilling the ability of the employer to provide the program for those who do want it.

Another factor that must be remembered is individual circumstances. For example, a 401(k) profit-sharing plan is usually among the most popular of employee benefits. But, in order to participate employees must be earning enough to have sufficient dollars "left over" to save, whether on a before- or after-tax basis. Thus, employees with big expenses and/or smaller earning capabilities will be less able to participate fully in the plan, even if they want to do so.

This "affordability factor" is not solely a function of the employee's income. Family size and expense, income earned by other family members, and retirement plans provided by spouses' employers will have a significant effect on the overall percentage of 401(k) plan participation. If an employer has a larger than average number of employees who are the sole breadwinners of their families, the overall percentage of participation will be lower. Conversely, a higher than usual number of workers whose salaries are one of two or more in their families will create a higher participation level. A business with only five employees will feel the effect of even one employee who elects to not participate, whereas the firm with 500 employees can accommodate a decision to opt out without threatening the level of participation available to the remaining employees.

It is this scenario that creates difficulties with the seemingly popular "no more than 25% of benefits can go to key employees" test. It is an economic fact of life that higher-income employees can afford and are more inclined to build long-term savings. The lower-paid clerk's decision to participate at a smaller level, or not at all, should not penalize those whose length of service and hard work have earned them sufficient income to save a larger amount.

Further, ours is an exchange society, governed to at least some degree by the law of supply and demand. The key employee with a history of long hours, dedication and personal involvement in the business is probably justifiably entitled to a larger share of the rewards of the business' efforts. Put simply, there are always going to be some employees whose production earns them larger economic rewards. This is particularly true when the rewards are provided at a substantial cost to the employer/business, even when the tax subsidy is considered.

Another problem with the 25% test is purely numerical. Larger firms with bigger work forces will likely be able to meet the percentage test. There will be a sufficiently large pool of employees to accommodate the choice to opt out or participate at a smaller level. It will be much harder, if not impossible, for smaller firms. And smaller firms are the ones spurring economic growth.

Data from Dunn and Bradstreet prove this. Using a data base of 5.4 million businesses in the U.S., the figures show that 53% of all firms have only four or fewer employees. Firms with fewer than 10 employees account for 72% of all U.S. businesses, and fully 79% of our nation's businesses employ fewer than 15 workers.

Is it fair to provide a tax subsidy for employee fringe benefits that, because of the strings attached, can be offered only to the employees of large businesses? Is it fair, or even sensible, to give a competitive edge to big business when it is small business that is providing the bulk of America's economic growth and jobs?

Thus, NALU urges you to study the implications of any proposed discrimination test very carefully. We agree that as a general principle tax-subsidized employee benefits should be available to all workers, including those who do not work for corporations. But the rules designed to assure this result must be flexible enough to accommodate the needs of small business, and the economic reality that some employees will earn and deserve a greater reward. It is true that we the taxpayers bear the cost of the tax subsidy. But we the taxpayers are also the beneficiaries of the economic growth spurred by the extraordinarily productive workers among us. Therefore, it is appropriate for us the taxpayers to share in the cost of providing their reward. The appropriate discrimination rules must also reflect the fact that the exercise of individual choice can and will allow yet greater cost efficiency and effectiveness but also can and will impact substantially on rigid percentage-based discrimination tests.

<u>Is A Tax Subsidized Benefit Program More Efficient Than A Direct Government Program?</u>

Absolutely. Encouragement of those who are comparatively sophisticated financial planners--employers--minimizes the possibility of excessive, duplicative, inefficient or inadequate protection that could result from leaving the decision to a much larger pool of relatively less sophisticated consumers. Because our society will pick up the cost of a foolish decision to forego basic insurance coverage, it makes a lot of economic as well as social sense to provide incentives to the group--employers--most likely to make the wise decision to provide this basic protection.

Let us hypothesize the result of a decision to withdraw the incentive to provide employee benefits. Because the benefits cost, on average, 36.7% of payroll, many profit-minded employers would undoubtedly cut down on or drop their benefit plans rather than incur payroll tax costs on the value of the benefits or the additional cash compensation liability that would come from the inevitable reduction in real earnings experienced by employees who would become liable for income tax on the value of their benefits. The higher wage cost would be inflationary, too, as employers would pass the costs on to their customers.

From the workers' perspective, the negative impact is just as likely. Certainly, some employees--particularly those earning higher than average salaries--would purchase at least some protection on their own. But others--maybe most--would simply forego the protection, or settle for inadequate amounts, rather than stretch already tight personal budgets to absorb the after-tax cost of adequate protection.

Then, when these people or their dependents become sick or die prematurely, our already-burdened social programs would provide support. For example, in 1981 Medicaid alone paid out over $27 billion in benefits to 22 million recipients. Medicare paid an additional $5.8 billion to beneficiaries under age 65. And, inflation in these costs since 1981 has been some 15% per year. The tax expenditure for health insurance in 1983 was estimated at $18.6 billion. It is reasonable to predict that Medicaid and Medicare payments would increase by far more than $18.6 billion if as few as half of today's covered population chose to "roll the dice" and accept the risk of expensive illness--which ultimately would be paid for by Medicaid or Medicare--rather than purchase sufficient health care coverage with their limited fund of after-tax dollars.

The scenario gets worse under the possible variations. Consider, for example, the possibility (probability) of economic loss due to increased loss of production time as a result of sickness made more severe for lack of early treatment. (Early treatment would surely decrease if an individual, already struggling financially, had to pay 100% of its cost.) Consider loss of tax revenue from workers no longer working due to disability or loss of employment because of the cut-back in insurance in force.

An equally grim picture emerges when one speculates on the social cost of losing near-universal life insurance protection. Without insurance dollars to cushion the financial devastation of premature death of a breadwinner, welfare programs--i.e., our tax dollars--would support these newly bereaved dependents. The dollars-and-cents cost almost certainly would exceed the estimated $2.1 billion tax expenditure cost associated with tax-favored group life insurance.

Already there exists great controversy and concern about the plight of our nation's elderly. Contemplation of the possibility of adding potentially millions of ill-prepared or unprepared retired poor to the welfare rolls chills the blood of even the least compassionate of us. It would also boggle the minds of those charged with forecasting budget outlays for these programs.

On a purely financial basis, elimination of basic life, health and retirement insurance fringe benefits could well be far more costly than the concededly large tax expenditure projections associated with these benefits. When you consider the price in human dignity, quality of life and peace of mind, the prospect is even more threatening.

Also, the flexibility possible under the current tax law is highly beneficial. The ability of an employer to select among a broad range of benefits allows firms to add protection as their businesses stabilize and their employees demonstrate loyalty and productivity. And the most flexible of all programs, cafeteria plans, not only maximize the effectiveness of an employee benefit program, they also maximize the effectiveness of the tax subsidy. This is because only those benefits that are actually wanted are provided, thus eliminating a subsidy for unused or unwanted benefits. And the tax expenditure cost should logically decrease. This is because only already tax-free fringe benefits are permitted options in a flexible spending salary reduction cafeteria plan. So the tax cost of the benefits is already reflected in the tax expenditure estimates for each specific fringe benefit code provision.

Further, cafeteria plans are becoming increasingly important and effective mechanisms for the control of health care costs at the consumer level. So long as cafeteria plans contain a cash-out or roll-over feature, participants can actually benefit, visibly, from efficient use of health care services. Yet, their health care needs are still fully protected. To gut or eliminate one of the few demonstrably effective tools for slowing the rate of health care cost inflation would be a costly mistake.

<u>How Do Tax Laws Affect Compensation Planning?</u>

With top income tax rates at 50% for individuals and 46% for corporations, tax implications are among the most vital of all factors underlying employers' compensation decisions. And, the business people with decision-making authority in the compensation area are typically extremely sensitive to the tax implications of their plans. Thus, the usual compensation-related decision will be based on a careful evaluation of how to provide the maximum competitive <u>after-tax</u> compensation package.

<u>How Do Tax Incentives For Fringe Benefits Affect Employment Choices?</u>

Most employees at all earning levels consider the benefits package as carefully as they consider salary, job content and working conditions when they are choosing among prospective employers. The benefits package becomes even more important as workers climb their career ladders.

To the extent that overly harsh discrimination rules preclude or limit small businesses' ability to design and offer competitive compensation packages, employee benefits law gives a competitive advantage to larger, more established firms. Small businesses have a tougher time attracting and retaining the best-qualified people, particularly at key management and executive levels. The cost of hiring employees is higher because compensation must be greater to compensate for benefits that the smaller employers cannot match or offer at all. In turn, the small business' products or services must be priced higher to make up for the higher cost of personnel.

Summary

Fringe benefits are a proven way by which economic prosperity is shared among all workers. They are more cost-effective than reliance on individual initiative as a way of assuring a basic level of risk-resistant security. The tax incentive given to employers to provide these benefits is the best way known to minimize the cost of compassionate caring for all members of our society.

However, while tax-favored fringe benefits must be available to all workers, caution must be exercised to be sure that the incentive to reward productivity remains and that individual needs and choices can be accommodated.

Finally, to the extent that discrimination rules are required, they should be as simple and as uniform as possible, but most importantly, they must not, by design or operation, discriminate against small businesses.

As this committee undertakes the task of reviewing and, potentially, changing the body of employee benefit tax law, you should keep these principles paramount: Fringe benefits help build a healthier, more productive economy and a healthier, more productive society.

Thank you.

TESTIMONY
OF THE
BLUE CROSS AND BLUE SHIELD ASSOCIATION

TAX TREATMENT OF EMPLOYEE BENEFITS

BEFORE THE
SENATE FINANCE SUBCOMMITTEE ON TAXATION

PRESENTED BY:

MARY NELL LEHNHARD
VICE PRESIDENT

July 26, 1984

Mr. Chairman and Members of the Subcommittee, I am Mary Nell Lehnhard, Vice President of the Blue Cross and Blue Shield Association, the national coordinating organization for the 96 Blue Cross and Blue Shield Plans. Today, Blue Cross and Blue Shield Plans provide health care coverage for more than 85 million Americans. Most of our subscribers maintain this coverage through group policies offered by their employers, although a substantial number — 13 million — are covered under individual health benefits contracts.

I appreciate this opportunity to present the Association's views concerning the tax treatment of employee benefits.

Current tax policy clearly establishes incentives for employers to provide certain employee benefits — particularly those that protect workers and their families against loss of income or high expenses due to retirement, disability, illness, and death. There are two major principles underlying this policy. The first is that assuring the economic security of active, disabled, and retired workers and their dependents is beneficial to society as a whole. The second is that government-operated programs alone cannot and should not be expected to achieve the goal of economic security for this population.

We believe these principles are as valid now as they were 30 years ago when the basic tax treatment of employee benefits was codified. In our view, the fundamental issue is not whether government should be involved in protecting workers and their families from loss of income or the high costs of illness but how the government should be involved. Government involvement can be through incentives in the tax code for the private sector to establish and operate benefit programs, or through the expansion of benefit programs operated directly by the government. We believe that the encouragement of private sector benefit programs is the better alternative. Therefore, we recommend that the current tax incentives for certain employee benefits be preserved.

Tax Treatment of Health Benefits

Because we are most familiar with the provision and utilization of health benefits, we would like to focus our specific comments on the tax status of employee health benefit plans.

Current tax policy encourages the provision of health benefits through employment by not treating the costs an employer incurs to provide these benefits as taxable income to the employee. In addition, the employer does not pay payroll taxes — such as FICA and unemployment — on these costs. These tax policies have been a major factor in the growth of employment-related health coverage. Three quarters of the labor force have employment-related health coverage. This coverage provides protection for about 177 million employees and their dependents.

We believe that this country's extensive group health benefit coverage has had substantial value for workers, employers, health care providers, the government, and society as a whole. Workers, including those who could not afford to buy insurance, or who would otherwise fail to purchase it on their own, are protected from the unexpected and major costs of illness. Health benefits administered and financed through a group of employees are less expensive than if comparable insurance were purchased by individual workers. Moreover, the employer can serve a valuable role in the health insurance marketplace as a well-informed bargaining agent for his or her employees. Through this bargaining and negotiation, employers can tailor a unique health benefits program that meets the often diverse needs of workers and their families as well as the needs of retirees and their dependents. In addition, employers are able to attract and retain workers through the provision of health coverage and the inclusion of particular benefits. Finally, employee morale and productivity are enhanced as a result of increased job satisfaction, and this, in turn, strengthens our economy.

By encouraging private group health benefits, current tax policy also has positive effects on our health care delivery system. Providers of health care services, particularly hospitals, are assured of payment for their services. In other words, insurers play a major role in avoidance of hospital bad debts, and that means a significantly smaller role for the federal and local governments in support of community hospitals.

Finally, and importantly, existing tax policy reduces the need for expanded government funded and administered entitlement programs.

Because group health coverage is a benefit which is critical to our nation's well-being and productivity, the present tax treatment of health benefits is particularly appropriate. Accordingly, the Blue Cross and Blue Shield Association strongly opposes the taxation of employer-provided health benefits.

I would now like to comment briefly on proposals to limit the current tax exclusion that applies to employer contributions to health benefits plans.

Proposals for a Tax Cap on Employee Health Benefits

The present Administration and some Members of Congress favor taxing the value of employer-provided health benefits above certain levels — the so-called "tax cap." While, to some, a tax cap may seem to represent a convenient shortcut in dealing with the federal deficit or an effective way to control health care costs, the adverse consequences for millions of Americans would be serious.

We believe that the adoption of this type of proposal would be both bad tax policy and bad health policy for the following reasons.

- <u>A tax cap would diminish the government's commitment to use tax incentives to have the private market provide protection against health care costs.</u> A major objective of our tax system is to encourage the private sector to undertake socially useful activities in order to minimize the need for tax-supported government programs. A tax cap on health benefits would send a signal that government had reduced its commitment to protecting the health of the work force and their families. Enactment of even a high level tax cap would be deceptive. Once in place, the temptation to "rachet down" the cap each year — in search of new revenues — would prove irresistible.

- <u>A cap would impose a "sick tax" on older and chronically ill workers, and on their employers.</u> Different employee groups have different health care needs. Because older and chronically ill workers tend to use more health benefits, the cost of providing health benefits to a group in which these workers are heavily represented will be higher than the cost of health benefits for a group of young healthy workers. Consequently, if a cap were imposed on the amount of employer-provided benefits, or for that matter if all of the health benefits were taxed, employees of companies with a relatively high percentage of such workers would have to pay more taxes than workers of other companies.

A tax cap could also have other serious but more indirect adverse effects on older and chronically ill workers. If employers responded to the tax cap by offering employees a choice of plans — a low option which is non-taxable and a high option which is taxable, those who perceive themselves as healthier likely would choose the lower-cost, minimal coverage plan. Less healthy workers would want the protection of a more comprehensive, higher-cost plan. Over time, the cost of providing services to the high users would drive up the premium of that group and the healthier workers would drop out. This "adverse selection" would put the cost of the more comprehensive protection out of reach for those who need it.

While we do not have precise estimates of the financial effect of a tax cap on groups with "high risk" workers, Blue Cross and Blue Shield Association actuarial simulations suggest how the Administration's proposal might affect older workers. The additional taxable income for family coverage provided by a particular Blue Cross and Blue Shield Plan (with a 75 percent employer contribution) is estimated to be 31 times higher for workers employed in older employee groups (average age 55-64) than in younger groups (average age 35-44). Under the Administration's proposal, this would mean taxable income of $1,306 versus $41.

- A cap is not needed to contain health care costs. Cost containment has recently emerged as the major factor in the delivery and financing of health care. Purchasers of health care, as well as providers have increased their level of sophistication in a very short time. Programs have been developed to reduce inpatient lengths of stay, to determine whether services such as diagnostic tests and surgery should be performed on an outpatient rather than on an inpatient basis, and to determine prior to hospitalization whether a hospital admission is warranted. For example, by using hospital utilization review, Blue Cross of Iowa cut small group premiums by a total of $24 million, and Blue Cross of Northeast Ohio cut experience-rated group premiums by 4 to 6 percent.

Another approach being used to control costs is the offering to employees of financial incentives to use designated hospitals and physicians in the community that, through a contract, will provide health care services for a lower price or with more stringent utilization controls. These new arrangements are called Preferred Provider Organizations — PPOs — and have demonstrated significant savings. For example, by using preferred providers arrangements, Blue Cross of California has cut premiums for large group accounts by an average of 13 percent, while Blue Cross and Blue Shield of Minnesota reduced rates by an average of 10 percent, saving $10 million. A variant on the PPO approach is called "selective contracting," in which an insurer or employer contracts with selected providers in the community whom they know provide high quality services at lower cost. Employees are not reimbursed for their medical expenses if they go to providers not covered under the contract. This also has resulted in lower health care costs for employers.

In addition, more and more employers also are offering their employees the option of a health maintenance organization — an HMO — since HMOs have strong financial incentives to control utilization of services while still providing high quality of care.

These approaches are helping to contain the cost of group health benefits. The Business Roundtable's Task Force on Health has just reported that, as a result of various steps taken by its members, average health care spending per recipient for the first quarter of 1984 increased only 8.4 percent from the first quarter of 1983 compared with 12.7 percent for the same period a year earlier.

- A cap would be regressive taxation. Data from the Congressional Budget Office and the Employee Benefit Research Institute show that, of those employees who would be subject to additional taxes, the financial burden would fall heaviest on those with lowest incomes. For example, under the Administration's proposed cap, workers who earn less than $10,000 a year would pay an additional 2.8 percent of their income on average. Workers earning more than $50,000 a year pay taxes equivalent to only 0.4 percent of their income. Reducing the benefit package to a value below the cap, could result in dropping covered benefits or providing for significantly greater employee cost-sharing. Because lower-income persons are less able to pay, any new cost-sharing requirements or out-of-pocket costs for non-covered benefits would affect them disproportionately.

For all of these reasons, we believe that Congress should not tax employment-related health benefits. Some might charge that the current tax status of employer-provided health benefits is inequitable because it applies only to health coverage obtained through employment. While it is true that health insurance premiums for those who must purchase individual coverage are paid for with after-tax dollars, the medical expense deduction has helped mitigate this expense. If Congress wishes to address the differences in tax treatment of employer-provided versus non-group health coverage, we suggest reconsideration of the 1982 change which raised the threshold for claiming the medical expense deduction from three percent to five percent of adjusted gross income, and eliminated the separate deduction for health insurance premiums up to $150. Restoring the separate premium allowance, in particular, would represent at least a partial solution to this problem.

Summary

In conclusion, we want to emphasize the value of using tax policy to encourage the private sector to provide benefits which protect our citizens from economic insecurity. With respect to health benefits, we strongly recommend that Congress not impose a tax cap or other form of tax on employee health benefits. Such a tax is not needed and would hurt those most in need of health care.

We look forward to working with you in this important area and would be glad to answer any questions you may have.

STATEMENT OF MARY NELL LEHNHARD, VICE PRESIDENT, BLUE CROSS & BLUE SHIELD, WASHINGTON, DC

Ms. LEHNHARD. Mr. Chairman, I am Mary Nell Lehnhard, Vice President of the Blue Cross & Blue Shield Association. The Blue Cross & Blue Shield plans provide health care coverage through group policies offered by employers for about 70 million workers and their dependents. Current tax policy clearly establishes incentives for employers to provide employee benefits, especially those that protect workers and their families against loss of income or high expenses due to retirement, disability, illness, and death. We believe that there are two fundamental principles underyling this policy.

The first principle is that assuring the economic security of active, disabled, and retired workers and their dependents is beneficial to society as a whole. The second principle is that Government-operated programs alone cannot and should not be expected to achieve the goal of economic security for this population. We believe that these principles are just as valid now as when they were incorporated as part of the Code 30 years ago. In our view the fundamental issue is now not whether the Government should be involved in protecting workers and families, but how. Goverment involvement can come through incentives in the Tax Code for the private sector to establish and operate benefit programs or through the expansion of benefit programs operated directly by the Government. We believe strongly that the encouragement of private sector programs is a far better alternative. We therefore recommend that the current tax incentives for employee benefits be preserved. Because the Blue Cross & Blue Shield Association is of course most familiar with the provisions of health benefits, we would like to comment specifically on tax treatment of employee health benefits. We believe that this country's extensive group health benefit coverage has immeasurable value for workers and employers, health care providers, the Government, and society as a whole. Workers, including those who could not afford to buy insurance or who would not purchase it on their own, are protected from unexpected and very major costs of illness. Importantly, existing tax policy reduces the need for Government-funded entitlement programs. We believe that the adoption of any tax on employer-provided health benefits including the so-called tax cap would be both bad tax policy and bad health policy. Specifically, a tax cap would erode the Government's commitment to use tax incentives to have the private market provide these benefits. Enactment of a high level or very generous tax cap would be deceptive. Once in place, the temptation to ratchet down the tax cap each year in its desperate search for revenues, would prove to be irrestible. Second a tax cap would impose a sick tax on older and chronically ill workers who have higher health care costs. For example, according to our calculations, the additional taxable income could be as much as 30 times more for workers employed in older groups than in younger groups.

Finally, a tax cap would be regressive taxation, contrary to what we have heard before. Those employees who would be subject to additional taxes under the proposal—the financial burden would fall heaviest on those with the lowest incomes. Under the administration's proposal, workers who earn less than $10,000.00 a year would have taxes equivalent to almost 3 percent of their income on average. Workers earning over $50,000 a year would pay taxes equal to only four-tenths of a percent of their income. For all of these reasons, we believe that Congress should continue to recognize the value of using tax policy to assure that the private sector protects workers against economic loss and specifically that Congress should not enact legislation to tax employment related health benefits. Thank you.

Senator PACKWOOD. Let me ask each of you one question. I will start with Mr. Hurd. I indicated earlier, that we are starting to see, at least in new contracts some addition of deductibles or copayments on health insurance. Employers are simply being driven to that, and many of the collective bargaining agents are going along with it. If you have any factual evidence you can give me for the record, I would appreciate it. Mr. Hurd?

ADDITIONAL MATERIAL FOR RECORD SUPPLIED BY HEALTH INSURANCE ASSOCIATION FOLLOWS:

The following material is submitted in reply to your request for data on trends in cost sharing provisions of group health benefit plans.

Hewitt Associates of Lincolnshire, Illinois recently released the findings of its study which compares the features of the principal benefit plans provided by 250 major employers in the U.S. for their salaried employees, from 1979 through 1983. A copy of the description of that study and the statistical results for medical expense coverage follows.

In essence, the results reflect the following trends:

1. *More employee sharing of hospital costs.*—The percentage of plans providing 100 percent reimbursement for hospital costs decreased from 89 percent in 1979 to 75 percent in 1983.

2. *Greater use of front-end deductibles, applicable to all medical expenses.*—In 1979, 14 percent of the plans had a front-end deductible. In 1983, the proportion was 32 percent.

3. *Increase in the size of annual deductible amounts.*—Only 15 percent of the plans had a per-person deductible of more than $100 in 1979. By 1983, the percentage was 32 percent. The major movement has been to deductibles of $150 more per year.

For each of the above, the change was most dramatic between 1982 and 1983. Also shown are trends toward increased use of placing a limit on an insured's out-of-pocket expenses and higher lifetime maximum benefits.

HRI'S HEALTH CARE COST CONTAINMENT SURVEY
COVERS PLAN DESIGN, SAVINGS, COST CONTAINMENT ACTIVITIES

EBPR RESEARCH REPORTS
PUBLISHED BY CHARLES D. SPENCER & ASSOCIATES, INC.
222 W. ADAMS STREET • CHICAGO, ILLINOIS 60606 U.S.A.

The Health Research Institute has released results from its Third Biennial Health Care Cost Containment Survey of corporate health care cost containment efforts. A total of 610 of the 1,500 largest U.S. corporations responded to the 1983 survey. The 41-page report analyzes trends and provides ideas and opportunities for planning cost containment efforts.

HIGHLIGHTS

The Health Research Institute asked 610 of the 1,500 largest U.S. corporations about their cost containment programs in group health plans. The survey covers plan design features, estimated savings, and corporate activity in cost containment/health promotion programs to address the issue of rising health care costs.

This Research Report is a summary of the Third Biennial Health Care Cost Containment Survey. For further information, contact William E. Hembree, director, Health Research Institute, 49 Quail Ct., Suite 200, Walnut Creek, CA 94596; telephone (415) 676-2320.

Plan Design Features

Responses to a question about the basic design of medical programs indicated that a substantial shift has occurred over the past two years, which shows 53.6% of the 1983 survey respondents using a comprehensive health plan approach. This is in contrast to 1981, when 39.1% used the comprehensive approach, and in 1979, when 32% used it. Respondents reported a substantial (and continuing) growth in dental plans (59% in 1979, 74% in 1981, and 77.4% in 1983). Prevalence of short term disability and long term disability plans has shown little change over the past two years, 71.4% and 83.7%, respectively. Vision care plans increased from 15.9% in 1981 to 19.3% in 1983. Although prescription drug plans dropped slightly from 13% in 1979 to 12% in 1981, there was an increase in 1983 (18.3%). About 0.3% of respondents in the 1983 survey offered prepaid mental health plans and flexible/cafeteria plans.

The pattern described by the 1979 and 1981 surveys of high maximums and reasonable and customary reimbursement patterns continued in 1983. However, there has been a shift away from the "nearly everything covered" approach. The proportion of respondents reporting full payment of semiprivate or R&C hospital charges for room and board dropped from 90% in 1981 to 85.5% in 1983. Similarly, 61.3% used unlimited or R&C charges for payment of hospital miscellaneous or ancillary charges (compared with 66% in 1981). A slightly smaller proportion used R&C charges as the payment basis for surgeons in 1983 (57.3%, compared to 59% in 1981). In 1983, about two-thirds of the respondents used limitations on payments for outpatient diagnostic lab and X-ray and doctor office visits, an increase over prior surveys.

The 1983 survey's average "composite" plan included a $100 deductible, 80% coinsurance with a stop-loss after $1,000 out-of-pocket expenses, and a plan maximum of $500,000 or more. The emerging "lean" plan included a $200 deductible with a $2,000 stop-loss that applied to new limits like room and board daily maximums, ancillary limits, surgical schedules, hospital deductibles, and stop-loss limits based on salary levels. The "lean" plan maximum was from $250,000 to $500,000.

Special Coverages

The inside limits for certain coverages have prevailed into 1983, although there is a shift toward full coverage, as shown in the following table:

	Percent Covered In Full		
	1979	1981	1983
Alcohol abuse treatment	31.1%	39.4%	46.1%
Drug abuse treatment	32.6	39.2	40.8
Home health care	28.2	32.6	46.5
Mental/nervous conditions	19.0	23.8	22.1
Physical therapy	54.5	56.9	66.8
Weight control	4.1	6.5	5.7
Nutrition/diet counseling	3.0	2.6	

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HRI'S HEALTH CARE COST CONTAINMENT SURVEY COVERS PLAN DESIGN, SAVINGS, COST CONTAINMENT ACTIVITIES

Respondents reported that 85% provide mental health services through their major medical/comprehensive plans, but the plans frequently limited outpatient care. In addition, 36.8% provide employee assistance programs to help employees cope with mental health problems, 9% provide plan design incentives to use outpatient services, and 0.3% offer a prepaid psychological plan. Most plans (except for EAPs) provided the same type and level of benefits for employees and dependents.

Hospice care coverage nearly tripled over the two-year period; in 1983, 35.2% of the responding employers covered such care, compared to 12.6% in 1981.

The coverage of second surgical opinions increased from 66.9% in 1981 to 73.2% in 1983. Mandatory second opinions (for all procedures) nearly doubled from 2.1% in 1981 to 3.6% in 1983. In past surveys, no question was included about a specified procedures list for second opinions. However, more than one-third (34.3%) of the responding employers used this approach in 1983. Nearly all employers who use second opinions pay for the second opinion in full, whereas less than 12% encourage a second or third opinion from a non-surgeon. Employers who kept statistics determined a savings of 2.8%

Precertification to determine the duration of nonemergency hospital lengths of stay was reported by 16.3% of the responding employers. The 1983 level of savings was 3.6% (up from 1.0% in 1981).

Ambulatory Care

Companies are increasingly recognizing that hospitalization, which is the most expensive component of health care costs, can be reduced through efforts to shift utilization from the inpatient to the outpatient or ambulatory setting. For example, in 1979, 59% of the respondents encouraged and provided coverage for ambulatory care; in 1981, 84%, and in 1983, 98.0%. The survey continues to note a trend that encourages use of preadmission testing. In 1981, about 85% of the respondents' coverage levels for outpatient preadmission testing were equal to the level paid in the inpatient setting for the same tests. Over the two years, the proportion reporting equal coverage levels dropped to 78.9%, while the proportion reporting outpatient preadmission testing paid at a higher level than inpatient more than doubled, from 4.2% to 10.1%.

The trend toward greater use of ambulatory surgery also continued. In 1979, 90% paid for ambulatory surgery, compared to 92.3% in 1981, and 98.0% in 1983. Similar to preadmission testing, the proportion of respondents providing an equal benefit, whether surgery was performed in and/or out of the hospital, has dropped from about 92% to 74.1% in 1983. By contrast, the proportion paying more for outpatient surgery has increased from 6.4% in 1981 to 20.7% in 1983.

Included for the first time in the 1983 survey was the use of innovative incentive-based systems. About 0.5% of the responding employers make medical expense accounts available to employees, or cash bonuses to either providers or employees. However, more than 26% make higher levels of payments available for use of outpatient facilities, and nearly 9% waive the deductible and coinsurance when alternative sites or treatments are used.

Funding/Administration Methods

When compared to the previous surveys, the 1983 data show a marked shift away from fully-insured, carrier-administered financing arrangements. In 1983, 17.3% of the respondents were using a fully-insured approach, compared to 27.8% in 1981, and 45% in 1979. The result of the shift seems to suggest employers may be changing financing arrangements but are remaining with their present or another carrier for claims administration.

In 1983, third-party administrators were reported by 42.9% of the respondents, compared to 23.6% in 1981 and 20% in 1979. Self-funded, self-administered plans declined in 1983 to 10.7%, down from 11.2% in 1981, which was almost double those in 1979. The use of alternative funding and administration methods resulted in an 8.0% savings, up from the 6.7% reported in 1981.

The majority of the companies (64.5%) have conducted internal audits to monitor eligibility determinations, claims processing efficiency, etc., compared to 49% in 1979 and 56.9% in 1981. In marked contrast to the prior two surveys, however, the proportion of companies conducting an audit of external administrators has increased to 55.1% (from about 39% in 1979 and 1981).

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Coordination Of Benefits

The proportion of respondents with a coordination of benefits provision increased from nearly 95% in 1981 (up from 92% in 1979) to 97.6% in 1983. The overall level of COB savings reported in 1983 was 9.3% (compared to 7.3% in 1981, and 6.2% in 1979).

Concurrent utilization review was used by 17.3% of the 1983 survey respondents, 18.8% used retrospective utilization review, and 6.6% used physician review. The savings levels reported for concurrent utilization review increased by nearly 50% to 6.1%. Savings levels for retrospective review were insufficient to report in 1981 but showed a savings of 1.2% in 1983.

Nearly 60% of the respondents have subrogation clauses and 65.1% actively pursue possible recoveries. Where subrogation is actively sought, recoveries are 2.3% of claims (up from 1.9% in 1981 and 1.7% in 1979).

Alternative delivery systems activity reported by 1983 survey respondents is as follows:

HMOs	67.4%
Preferred provider organizations	2.3
Efficient provider organizations	1.3
Prepaid psychiatric care	0.3
Insurer/physician health plan	1.1
Health care alliance	1.3
Holistic health care	0.7
Expanded industrial (in-house care)	6.3

Although only 2.3% of the respondents offer a PPO, more than ten times as many (26.6%) expect to offer a PPO within two years. Similarly, more than three times as many expect to offer an efficient provider organization (4.0%), and nearly five times as many (1.7%) expect to offer a prepaid psychiatric care plan. Part of the reason for respondent interest in other forms of alternative delivery systems may be the decline in reported savings from use of HMOs (from 8.5% in 1981 to 2.4% in 1983).

Respondents reported increases in the use of alternative care treatments. The proportion providing coverage for biofeedback training increased from 15.1% to 22.6% over the two-year period. Home birth coverage increased from 11.7% to 20.9%; cancer and terminal illness counseling was provided by 23.3% of the respondents; hypnosis increased from 1.7% to 7.3%; and stress management and pain management services were covered by 12% to 15% of the companies. Since these alternative care treatments require employees to take a more active role in their health, employers are encouraging this trend in their benefit plan design to support and reinforce a greater acceptance of responsibility and involvement.

Health Improvement

Nearly 30% of the employers responding to the 1983 survey provide for early detection screening, compared to 21.7% in 1981. Health risk assessments were provided by 10.3% of the respondents at the work site. Data show a reduction in use of periodic physical examinations; 13.0% provided physicals for all employees, compared to 16.0% in 1981. The proportion of companies providing pre-employment physicals for all employees declined from 42.6% to 31.2%, but increased for selected employees (from 13.4% in 1981 to 16.3% in 1983). Executive physicals declined from 63.4% to 53.8%. A new question included in this year's survey found that 7.6% of companies provided physicals for employees with identified risk factors. Although savings levels were not statistically significant, the average level of reimbursement reported for outside physicals was $106, and the average maximum was $210.

The proportion of employers providing incentives for health improvement behavior change has increased in nearly all categories. Seven percent reward employees for sick time not taken (down from 12.6% to 7.0%), smoking cessation payments or contests increased from 1.7% to 5.3%, payment for weight loss increased from 0.3% to 4.0%, bonuses for less than expected medical care costs increased from none to 1.3%, and those providing bonuses for non-use of the plan increased slightly from 0.3% to 0.7%.

Health education communications has shown a significant increase since 1981. For example, the proportion of respondents using posters increased to 38.2%, internal publications (to 34.6%), payroll stuffers (to 13.0%), and audio-visual (to 19.6%). Use of newsletters declined from 20.3% to 16.3%, and use of single purpose memos declined significantly from 30.0% to 12.0%. In addition, 6.3% of employers have conducted an interest survey to determine employee need for health education information, and 5.0% adopted a comprehensive communication campaign.

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HRI'S HEALTH CARE COST CONTAINMENT SURVEY COVERS PLAN DESIGN, SAVINGS, COST CONTAINMENT ACTIVITIES

One of the ways major employers are approaching health care cost control is through actions in the community and government sectors. Coalition participation has increased significantly: 14% in 1979; 30.3% in 1981; and 61.8% in 1983. Companies that have tried joint management/union cost containment efforts increased from 11.1% in 1981 to 18.9% in 1983. Of the respondents reporting such joint efforts, 68.4% report the union has been generally cooperative.

To gain top management's support for cost containment health improvement programs, some companies initiated a formal policy statement. The proportion reporting a written and agreed-to statement of objectives has more than doubled, from 14.0% in 1981 to 28.2% in 1983. Where objectives had been set, they included a health care cost containment task force (24.0%), benefits reduction to maintain costs (14.6%), maintaining present level of benefits without cost increases (11.3%), and reduction in health care costs (10.3%).

Employers have continued to offer several types of employee choice-making opportunities. More than one-half (56.2%) offer an alternative delivery system, and about one-third (35.5%) allow employees to waive coverage entirely. Other options include dental plan (18.3%), vision plan (3.7%), prescription drug plan (3.0%); approximately 5% allow choice of the level of deductible and/or level of coinsurance.

Questions about employee cost-sharing were included for the first time in the 1983 survey. Employee involvement in costs included the following:

Increased deductible	
Individual	38.5%
Family	35.2
Increased coinsurance	19.6
Larger stop-loss	18.9
Limits on hospital payment	
Deductible (additional)	13.0
Higher coinsurance	9.6
Weekend exclusion	8.6
Premium (payroll) sharing	
Employee	18.6
Family	24.3

As in 1979 and 1981, a special analysis was conducted to determine whether activity in cost containment and prevention/promotion efforts have resulted in reduced costs. Respondents were segmented according to level of reported activity. Those reporting more than six significant cost containment efforts, and those reporting more than four prevention/promotion efforts, were compared to the remaining population to derive the following:

	Cost Per Employee	Cost As % Of Payroll
All participants	$1,366	8.6%
Active in cost containment	996	6.7
Remaining participants	1,438	9.1
Active in prevention/ promotion	1,061	6.9
Remaining participants	1,456	9.3

The report states: "It is difficult to escape the conclusion that those active in cost containment and prevention/promotion efforts are being rewarded for their efforts (to the extent of approximately 30% less cost). This reward not only manifests itself in terms of reduced direct employee health care costs (as shown above), but also in higher productivity while employees are at work, decreased absenteeism, decreased incidence of disability, premature death, etc."

Trends And Observations

The report states:

"The timing for innovative health care cost containment efforts has never been better. Employees and providers have generally accepted initial changes like cost sharing, "lean" plans, increased deductibles, and additional payroll deductions. Now they are more willing to accept outpatient incentives, medical expense accounts, prospective payments, competition, preferred providers, in-house care, pre-certification, health improvement/prevention efforts, joint labor/management councils, prepaid psychiatric care, alternatives to inpatient care, patient advocacy, etc.

"The decline in use of less effective early detection actions (e.g., physicals) and increases in prevention and focused early detection actions signals a fundamental new direction is emerging in prevention. It appears employers are using generalized tools (e.g., health hazard appraisals) to identify at-risk populations, then focusing resources on those who have (or are at the greatest risk for) serious illnesses."

* * * * *

National Governors' Association Center for Policy Research "Harnessing State Expertise to Contain Health Care Cost" February 1984

4. Cost-containment Activities

The final table, Table 4, provides information on the types of cost-containment activities that states have considered for their employee health benefit programs. Most states have introduced, or are planning to introduce, one or more of the traditional cost-containment strategies. In addition to the approaches mentioned in Table 4, states are also experimenting with wellness programs, patient auditor programs, flexible benefits, tightened auditing, tightened utilization review, pre-certification for selected procedures, and financial incentives for shortened hospital stays.

Although some states have already implemented substantial cost-containment strategies into their plans, others are just beginning to introduce broad packages of change. The case studies presented in Chapter II are of states already implementing cost-containment strategies, but it is also interesting to examine how some states developed the proposals they expect to implement. The way in which Vermont and Maryland developed their proposals offers an instructive contrast: Vermont's initiatives came from the executive branch and face a tough fight for approval from the union; Maryland's initiatives came from the legislature, and the union is inactive and not a major force in the discussion.

Vermont went to a self-insured, administrative services only (ASO) contract program in 1980, but realized that more changes were needed to curb the growth in expenditures. The state secretary of administration brought together a team of people with related experience, including officials of the Medicaid program, the insurance, banking, and health departments to review alternatives and come up with a proposal. A package was developed that proposed the following: a mandatory outpatient program for certain procedures and an incentive ambulatory program for other procedures; incentives for shortened stays and early maternity discharge; no payments for emergency room expenses, except for accidents and emergencies; and procedures for reduced claims handling. These proposals are now going through the collective bargaining process, and, if a contract is reached, must then be approved and funded by the legislature.

The Maryland legislature, concerned with the large increases in the cost of its employee health benefit plan, asked the Maryland Department of Budget and Fiscal Planning to study the program in depth, analyze the reasons for the cost increases and recommend administrative and program changes. The state review included a thorough review of actuarial data, administrative procedures, claims processing, equipment used, and funding options, as well as cost-containment strategies such as second opinion surgery, preadmission testing, home health and hospice care, cash incentives and fitness and lifestyle programs. The department completed a two-volume study in May 1983, recommending major revamping of the state program. The recommendations are currently being reviewed by a benefits consultant.

TABLE 4

TYPES OF COST CONTAINMENT STRATEGIES PLANNED
IN STATE EMPLOYEE HEALTH BENEFIT PROGRAMS

	Number of States		
	Planned	Not Planned	Already Implemented
A. Mandate or increase cost-sharing requirements (deductibles, co-insurance).	8	8	21
B. Provide fiscal incentives for cost-containment strategies such as second opinions for surgery, preadmission testing, ambulatory surgery, shortened stays, etc.	12	10	15
C. Require mandatory second opinions for surgery or preadmission testing.	10	18	6
D. Develop preferred provider plans, primary care networks, HMOs or other alternative finance and delivery systems options.	11	9	20
E. Adopt standard contribution (same contribution regardless of plan chosen) or other incentives for employees to enroll in cost-effective benefit plans.	3	18	12

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Mr. HURD. Yes, Senator, I have some specific comments. Our company primarily insures small and medium sized employers. We have on the order of 40,000 or 50,000 small employer-sponsored plans covering maybe 2 million workers. I went through the data on that just before coming out here, and I found that the first dollar coverage type of medical plan, as compared to those with a deductible on the employee's part, was only running 10 percent. Our total revenue flow from those programs is currently only—10 percent that even surprised me——

Senator PACKWOOD. Let me make sure I understand. Of the moneys you have coming in from health insurance, only 10 percent of it comes from plans that have first-dollar coverage.

Mr. HURD. Yes. So, this has been a vast shift. Now, we had essentially stopped selling, even offering, first-dollar coverage in the small employer market a while back. We still had it available for the larger plans, but I think there was a union negotiation problem, but yes, I think that there are changes happening and happening rapidly.

Senator PACKWOOD. Mr. Briggs?

Mr. BRIGGS. Our business is essentially more towards the very large employers. Most of the large employer have negotiated contracts, and that has slowed the shift to the deductible and coinsurance-type plans. Nevertheless, we have seen a substantial number of companies attempt to do this for their nonnegotiating employees, if nothing else. We know that many of them are planning to introduce deductibles and co-insurance in the very near future. We have our own employees as an example. We ourselves introduced a $350, approximately, deductible in our own plan as of January 1, 1984, and introduced 90 percent co-insurance pretty much across the board. This was a substantial change.

Senator PACKWOOD. $350 deductible per individual and then you paid 90 percent above that. They pay 10 percent? Is that what you are saying?

Mr. BRIGGS. Yes, except in certain cases where we want to encourage the employee to do things, in which case we will reimburse it in full.

Senator PACKWOOD. All right. Mr. Press?

Mr. PRESS. Yes, Mr. Chairman. A significant part of my business is from direct sales of health insurance to small businesses. We see a greater use of increased deductibles, moving from calendar year deductibles to per cost deductibles and in general, higher coinsurance limits. Additionally, we are seeing increased incentives shared by the employee and the insurer for saving money on medical care expenditures.

Senator PACKWOOD. Ms. Lehnhard?

Ms. LEHNHARD. Yes. I would say that we do see that trend, and I would make two points about it. First, the way it is happening employers are able to take a look at their employees and their financial need, and tailor the cost-sharing according to their ability to pay. For example, employers may not want to impose such high cost-sharing on their low income workers—clerical and secretarial—as their higher management level staff. The current system allows them to make that individual tailoring. That could not happen under a tax cap. Under a tax cap, everybody would be treated equally regardless of income.

The second point is that a tax cap imposed in an overnight fashion would mean that many unsophisticated employers would have to make a decision about how to cut their benefit package. Whereas, now it is an evolutionary process, talking to the insurer, the employee benefits manager, outside advisors, an overnight decision we believe could easily result in many companies dropping the benefits that we know reduce the most costly part of health care costs, hospitalization. For example, a surprising number of companies right now don't cover physician office visits, and we know that where they do, they reduce hospitalization. An overnight tax cap would, because of employees being scared about the high cost of hospitalization, would mean employers have never cover those cost effective benefits.

Senator PACKWOOD. OK. I have no more questions. Thank you very much.

Mr. HURD. Thank you, Senator, for having the hearings. We appreciate the chance to talk with you.

Senator PACKWOOD. I am happy to do it. We will reconvene at 9:30 in the morning.

[Whereupon, at 12:31 p.m., the hearing was recessed, to reconvene at 9:30 a.m., on Friday, July 27, 1984.]

FRINGE BENEFITS

FRIDAY, JULY 27, 1984

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Durenberger, and Grassley.

[The press release announcing the hearing follows:]

Senator PACKWOOD. The hearing will please come to order. This is the second in a scheduled 3 days of hearings on the subject of employee benefits I made a long opening statement yesterday. I will not repeat that today other than to say that these hearings were designed to discuss the philosophy of employee benefits and the philosophy of whether they should be taxed, rather than arguing about specific benefits. There is some testimony relating to specific benefits, and it integrates very well into the overall subject: We are going to be getting back into the specifics I hope later this year on educational benefits and clearly next year. Although I expect the President will be reelected; but, whether he is or whether he isn't, I think we are going to be back into this issue next year—in tax reform, and flat taxes, and the taxation of employee benefits, deductions, and others.

To everyone in this group, I think my philosophy on this subject is well known. All I will do today is remind the witnesses again of the time limits They have been previously notified. We had a choice when we scheduled these hearings—frankly, I did not think we would have as many requests for testimony as we had. We had about 110. There was Treasury in opposition, and 109 who basically wanted to speak in opposition to the Treasury's position. [Laughter.]

Not from public interest groups, not from anybody, was there any desire to speak on the side that the employee benefits should be further taxed or totally taxed. Everyone who wished to testify is a variant of what you will hear yesterday, today, and on Monday.

My choice was to pick a dozen or so witnesses and let them speak a half an hour at length and hope that they represented a cross section, or to do as we have done and to take about 70 witnesses, hold them to rather strict time limits, so that I could have a cross section of different companies, different trade associations, different child care groups, all presenting their interests. The only way I could do that was to tell you to put your entire statements in the record and talk as if you were talking to me in a living room; and I will, as I did yesterday, require you to adhere to the time limits rather strictly. So when that red light goes on, I will ask you to complete your testimony.

We will start this morning with a panel of Everett Allen, the vice president of Towers, Perrin, Forster & Crosby; Carson Beadle, the managing director of William Mercer-Meidinger; Susan Koralik, partner at Hewitt Associates; and Harper Garrett, vice president, Alexander & Alexander.

Unless you have objections, we will go in the order that you are listed on the agenda.

I have read all of the testimony that had been submitted as of last night. I have not read any testimony that may have been handed in today, but your entire statement will be in the record.

Go right ahead, Mr. Allen.

STATEMENT BY EVERETT T. ALLEN, VICE PRESIDENT, TOWERS, PERRIN, FORSTER & CROSBY, NEW YORK, NY

Mr. Allen. Briefly, in the time allotted, we would like to make six major points. The first of these is that there is a need for private plans and that the current system should support them.

National policy for private plans should not be driven by tax policy alone. The discriminatory practices which occur in a small percentage of plans should be eliminated in ways that do not adversely affect plans that are not discriminatory. Private plans should be permitted to integrate with Social Security benefits. And whatever our policy, it should be stable and not one where we have almost constant need of modification. And, finally, we should eliminate burdensome administrative requirements.

On the first point, the need for plans, we are dealing with the economic security needs of people in the event of old age, death, or illness, and in meeting the expenses associated with health care. Essentially, these have been provided through three major sources—the Government, employer-provided plans, and personal savings.

Now, of the three sources, the two that are most important are the Government and the private plans provided by employers.

We feel or we sense that underlying legislation in the past has been the tacit assumption that benefits will continue unchanged even in the face of onerous requirements. And frankly we don't think this assumption is valid; there is ample evidence that employers do respond to onerous legislation by reducing benefits, curtailing plans, terminating plans, or seeking loopholes. We should recognize this and encourage private plan coverage. If private plan coverage recedes because of onerous legislation or lack of tax support, then necessarily there is going to be a burden shifted to the Federal Government. Personal savings are not going to take up the slack; the needs are going to continue to exist; and if there is a lack of or a lessening of private coverage there will be pressure on the Government to make up the difference.

Senator Packwood. If I may interrupt you for a moment, nowhere are you going to see that. We have now lost the tax benefits for educational assistance plans. The bulk of those plans are not benefiting the highly paid employees. The employer sends their employees to a community college, and the tuition may be $200 to $300 a year. It is not an overwhelming expense for employees. But if you are going to have to withold on it and the employee is going to have to count it as income, I've got a feeling that a good many employers are going to say it just isn't worth the headache.

Mr. ALLEN. I agree. I think this is the danger. If we start doing things to the other plans—the medical programs and everything else—then the employers back off and we will have strong pressure on the Government to make up the difference. I am not at all convinced there is efficiency in doing that.

Senator PACKWOOD. Whereupon we are going to levy the tax on the employers to pay for the programs that the employers would otherwise pay for more cheaply and administer better if they administered it themselves.

Mr. ALLEN. Exactly.

Our second point is that national policy on benefits should not be driven by tax policy alone; we have lots of other considerations that have to be taken into account.

Just to give you one specific recent example, let's take the area of medical coverage for the elderly. The creation of adequate reserves for this type of benefit, we think, is very important and socially desirable. This has particular significance when you consider medicare. That was a program designed to provide health care for the aged, but with three successive pieces of legislation we have had a shifting of the cost of medicare benefits to the private sector—for active employees under age 67, in connection with the DRG type arrangement, and here we have the Deficit Reduction Act of 1984 which strongly discourages employers from funding post retirement medical benefits at a time when they are being given additional liability for this coverage. It seems to us to be totally inconsistent.

Tax policy is critical and powerful, but it has to be exercised very judiciously.

We have lots more points. I will just have to summarize them, because I think we are getting close to running out of time.

Discrimination has to be put into perspective. It exists, but, by golly, it doesn't exist in very many cases; it's a very small percentage of the total universe. We need much more of a rifle-shot approach to handling discrimination and tax abuse.

We think the integration need is critical. Social Security benefits are clearly skewed to the lower paid; and to provide adequate nondiscriminatory benefits for all, some form of integration has to be provided and has to be permitted. And most of the integrated plans—practically all, in fact—provide benefits that percentagewise tend in the aggregate to decrease as pay levels increase.

The need for stability in national policy is critical. We have had 7 tax bills in the last 10 years, 2 Social Security amendments, multiemployer withdrawal liability legislation, and antidiscrimination legislation in terms of age and sex. You hardly get one plan in place and supported by systems than you have to go around and change it again. We need something we can stabilize and live with.

Finally, whatever that is, it really should avoid these burdensome requirements that have been imposed by the Internal Revenue Service in terms of plan filings and the like. All kinds of disclosure information has to be filed, and it apparently serves no useful purpose.

As a closing comment, we would like to offer the facilities of our firm and our total cooperation in helping the committee in any way we can.

Thank you.

[Mr. Allen's written prepared testimony follows:]

STATEMENT OF

TOWERS, PERRIN, FORSTER & CROSBY

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARING ON FRINGE BENEFITS

July 26-30, 1984

We are very pleased to appear before your Subcommittee and offer our comments and opinions on issues relating to private employee benefit plans.

Towers, Perrin, Forster & Crosby is an international consulting organization specializing in employee benefits and related human resource consulting services. Our worldwide practice is devoted in large measure to helping companies manage all aspects of their pension and other employee benefit plans. We serve more than 5,000 clients, both large and small, in a broad range of industrial classifications, as well as in the government, education and health service sectors. We have some 325 clients among the *Fortune* 500 industrials, 85 of which are in the Top 100, and 220 clients among the *Fortune* 500 service companies.

We support these hearings and compliment the Subcommittee for its efforts in developing a full, fair hearing record with respect to employee benefit plans. We believe that there are many misconceptions concerning these plans -- for example, the level of "tax expenditures" associated with tax-favored benefits, the extent to which abusive practices exist and the magnitude of coverage and benefits provided for low- to middle-income individuals and their families. These hearings create the opportunity to establish a clear and objective record. We are confident that this record will show that private plans play an impressive role in providing economic security in a cost-efficient, nondiscriminatory manner for millions of participants and beneficiaries.

In our testimony, we will refrain from citing statistics concerning the prevalence of these plans, the extent of their coverage and so forth. This information will be supplied by such organizations as the Employee Benefit Research Institute. Rather, we will comment on several matters relating to national policy for private employee benefit plans. Specifically, we will address the following topics:

- There is a need for private plans;
- National policy for these plans should <u>not</u> be driven by tax policy alone;
- Discriminatory practices, which occur only in a small percentage of plans, should be eliminated in ways that do not adversely affect plans that are not discriminatory;
- Private plans should be permitted to integrate with Social Security benefits;

- Whatever our national policy, it should be stable; it should permit employers to put plans and support systems in place without the need for almost constant modification, as is now the case;

- Burdensome administrative requirements should be avoided.

The following presents more detailed comments on each of these items.

The Need for Private Plans

The economic security provided by private plans relates primarily to the need for continuing income in the event of old age, death or disability -- and the need to meet expenses associated with health care. Private plans now provide benefits to meet the needs of more than 150 million participants and their beneficiaries. Many of these benefits are funded in advance, thus creating a high degree of security.

Conventional wisdom contends that these economic security needs are met by the so-called three-legged stool -- government benefits, employer-provided benefits and personal savings. In reality, government- and employer-provided benefits are the more significant. Although personal savings are important for many reasons, they provide a much smaller part of total benefit protection than the other two sources. (Increasingly, personal savings are being channeled into employer-sponsored plans rather than into traditional savings vehicles.) Many reasons contribute to this relationship -- the effect of inflation on the ability to save, social pressures to improve one's standard of living, the relative illiquidity of some assets such as home equity, and so forth. Whatever the reason, most individuals look to the government and their employers for the major portion of their benefit protection.

We sense that underlying employee benefit plan legislation and regulation is the tacit assumption that benefits will continue unchanged and that new coverage and plans will continue to develop, even in the face of onerous requirements. This assumption is unwarranted. Ample evidence indicates that employers respond to adverse laws by curtailing benefits, by terminating plans and by seeking loopholes. The large number of pension plan terminations following ERISA is a good example of such employer reaction.

Our national policy should recognize this, and should encourage the growth of private plan coverage. The economic security needs of individuals will not diminish if their private plan coverage is reduced or eliminated. To the extent such coverage does disappear, it will create pressures for government benefits to expand and fill the gap.

In our judgment, it would be wrong to expand government programs beyond their current level. The Social Security system is beset by its own financial problems (despite the 1983 Amendments) and faces financial difficulties in the near future with its Medicare program. Indeed, the system's future financial integrity may very well depend upon the collection of additional revenues and/or the reduction of benefits. Increasing Social Security benefits will only exacerbate these problems and cause a relatively diminishing base of taxpayers to assume an ever-increasing burden of transfer payments.

Moreover, Social Security's pay-as-you-go financing does not contribute to capital formation -- a highly desirable feature that is part of the advance funding concept associated with many types of private plans.

National Policy Should Not Be Driven by Tax Policy Alone

Our national policy on employee benefit plans needs to reflect social and economic interests that go far beyond tax expenditures and the abuse of tax shelters. Many other factors need to be taken into account. They include:

- fiduciary responsibilities,
- disclosure requirements,
- capital formation,
- health care cost control,
- age and sex discrimination, and
- insuring plan obligations.

Tax policy has tended to dominate private employee benefit plan legislation. We believe this is totally inappropriate. Tax issues, of course, are important -- but they are not the only issues that should be taken into account; the Treasury and Internal Revenue Service should not establish or dictate social policies.

The fact is that tax policies can and often do conflict with other social and economic objectives. The following examples illustrate this point:

- Health care cost containment is a critical national concern. Nonforfeitable spending accounts and ZEBRAs (zero balance reimbursement accounts) are techniques that provide significant assistance in achieving such controls. In the opinion of many, these were and should continue to be techniques permissible under Section 125 of the Code. Yet for revenue considerations and concerns over potential tax abuse, the Internal Revenue Service held that such techniques violate the law. (In passing the Deficit Reduction Act of 1984, Congress has apparently sanctioned the Internal Revenue Service position.) In this instance, tax policy seems to conflict directly with the broader social objective of achieving health care cost control.

- Another example concerns ERISA's minimum funding standards. A critical objective of ERISA was to ensure adequate funding of defined benefit pension plans. In measuring liabilities to determine these minimum funding standards, actuaries are required to use assumptions that are reasonable in the aggregate. Under the law, there is a maximum dollar amount of benefit that can be provided for any employee, but this dollar amount (after a limited freeze period) will automatically increase to reflect changes in the cost of living. For revenue reasons, and despite the minimum funding and reasonable actuarial assumption requirements, employers are not permitted to determine plan liabilities by taking automatic increases in the benefit limitation into account -- even though they are stipulated by law. This revenue policy effectively prevents the full advance funding of liabilities for over one-half the current work force.

- Another area of conflicting policy relates to the establishment of a normal retirement age. The 1983 Social Security Amendments, for necessary financial reasons, changed the starting age for normal benefits to age 67 from age 65. Discrimination laws also serve to encourage employment beyond age 65.

ERISA, however, generally does not permit a maximum normal retirement age greater than 65. Although this is not the proper forum to state an opinion on what is appropriate, we do want to point out that policies are inconsistent.

- A final example concerns the funding of post-retirement welfare benefits. The creation of adequate reserves for these benefits, which can provide important security for all employees, is socially desirable. This has particular significance when one considers Medicare. This program was designed to provide health care coverage for the aged. With the Social Security Amendments of 1983 and the enactment of TEFRA and, more recently, the Deficit Reduction Act of 1984, we have had a series of changes in Medicare that shift costs to the private system as a way of solving government financial problems. However, the Deficit Reduction Act of 1984 strongly discourages employers from prefunding post-retirement medical benefits. The objective of this legislation was to correct alleged abuses; however, it will have a negative effect on benefit security for nearly everyone, including employees covered by plans that are clearly nondiscriminatory.

Tax policy is a critical and powerful force. It can serve to provide major incentives for the development and expansion of private employee benefits. It can also serve as a major disincentive -- as recent legislation has proved.

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Discriminatory Practices

The issue of discrimination in employee benefits needs to be put into proper perspective. Fewer than three percent of employees with pension plan and health insurance coverage earn more than $50,000 a year. And most of the coverage provided for this small group is not discriminatory. To the extent that there is discrimination, it involves only a very small part of the total employee benefit universe.

There is no question that discriminatory and abusive practices do occur from time to time within the current system. Insofar as possible, such practices should be eliminated. In doing so, however, it is important that Congress stop short of removing tax incentives that encourage the adoption of plans providing benefits for rank-and-file employees.

Past efforts to correct abuses have often adversely affected the entire benefit system. The top-heavy provisions of TEFRA are a good ex .ple of this. All plans must include these provisions, regardless of the plan's size or the likelihood of its becoming top heavy. And once the provisions have been included (whether in complete form or by reference), they must, under ERISA's disclosure provisions, be communicated to employees. This type of communication will serve only to confuse people in situations where top-heaviness is irrelevant. Similar observations can be made about the reserve and funding provisions of the Deficit Reduction Act of 1984; all plans must comply with provisions designed to correct abuses found in only a small number of situations.

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Clearly, for every action, there is a reaction. Imposing too many restrictions -- particularly when they are not necessary -- can cause plan terminations and deliberalizations. Management groups and owner-employees can provide for themselves through other mechanisms even though they are not as tax efficient. Thus, the real losers from restrictive legislation may well be the "average" employees who are eliminated from coverage and who have no adequate means of replacement.

Corrective legislation, if needed, should be directed at specific areas of abuse, and should not hamstring the entire system. Further, corrective legislation should be limited to tax-favored benefits. There is no need to impose restrictions on benefits otherwise taxable -- for example, group life insurance over $50,000, the cost of which is currently taxable as income to employees.

Self-interests have always existed and will continue to exist. In the long run, the public interest will best be served by a policy that harnesses these self-interests and uses them for the good of broad groups of employees. Such a policy requires accommodation, rather than conflict.

Integration With Social Security

In our judgment, it is imperative that national policy permit the integration of private plan benefits with those provided by Social Security. This applies to retirement, disability and medical expense benefits.

These two systems, private and public, are not mutually exclusive; each reinforces the other. The combination of the two achieves an equitable distribution of benefits at all pay levels. The failure or partial curtailment of either system transfers burdens to the other. For example, the Social Security Amendments of 1977 and 1983 reduced benefits for covered individuals. In both cases, many private plans automatically increased benefits to reflect the Social Security reductions.

The possibility of the reverse situation should be of particular concern to Congress, considering the financial difficulties Social Security faces. Any policy changes that have a negative effect on private plans and their benefit levels could, in turn, produce demands for increased Social Security benefits.

Social Security benefits are skewed in favor of the lower-paid. The following table shows Social Security replacement ratios at different final pay levels (in 1984) for both a single individual and a married couple, assuming the employee (and spouse) is age 65 at the beginning of 1984. The amounts are based upon a salary history consistent with the movement in national average wages.

1984 Social Security Replacement Ratios

Final Pay	Social Security Benefit as a Percentage of Final Pay: Single	Married Couple
$ 10,000	49.2%	73.8%
14,000	43.8	65.7
18,000	40.9	61.4
24,000	33.8	50.7
30,000	27.8	41.7
36,000	23.4	35.2
42,000	20.1	30.1
50,000	16.9	25.3
100,000	8.4	12.7

As can be seen, the replacement ratios for a single individual range between 49 percent and 20 percent at low- to middle-income pay levels. In contrast, the replacement ratio for someone earning $100,000 is only 8.4 percent. It should also be observed that Social Security benefits are income-tax free for most individuals. If these largely tax-free benefits are related to pre-retirement aftertax income, instead of to gross pay, replacement ratios are even higher.

The integration concept is often thought to permit discriminatory results -- that is, benefits that disproportionately favor the highly paid. Taken alone, integration of pension benefits does favor the highly paid, but under circumstances and requirements that rigidly control the extent to which this takes place. In essence, the express purpose of integration is to achieve income replacement levels -- from both public and private sources -- that remain constant or, as is almost invariably the case, decrease as pay levels increase.

The following table shows the replacement ratios achieved, from both sources, under the integrated pension plan of a major industrial organization. The total replacement ratio decreases from approximately 70 percent for lower-paid employees to about 50 percent for the higher-paid. This distribution of total benefits is not at all uncommon -- indeed, it is representative of the integrated pension plans of many major employers. It is hard to conclude that this produces discriminatory results.

Actual Income Replacement Ratios

Employees With 30 Years of Service at Age 65

Final Pay	Retirement Income as a Percentage of Final Pay
$ 10,000	71.4%
14,000	68.7
18,000	67.3
24,000	63.7
30,000	60.7
36,000	58.5
42,000	56.9
50,000	55.3
100,000	51.0

If integration is not allowed, and only uniform benefits are permitted at all pay levels, it will be impossible to provide total benefits that are fair and equitable for all employees. For example, if the private plan benefit level is set to provide adequate (not excessively high) benefits for mid- to upper-income employees, the total benefit (from the plan and Social Security) could exceed final pay for employees at lower-income levels.

(This poses an interesting question: Should tax policy support the cost of a pension plan that, in effect, allows people to retire at income levels that exceed what they earned while working?)

Alternatively, setting benefits at a level that prevents excessive benefits for lower-paid employees produces inadequate total benefits for the others. Neither result makes sense. Integration limits should be designed to permit the two systems, public and private, to distribute benefits in an acceptable, non-discriminatory manner.

National Policy Should Be Stable

Whatever our national policy for employee benefits, it should be stable. It was just ten years ago that ERISA was enacted into law. Since then, we have had two major Social Security amendments, additional legislation relating to age and sex discrimination, revision of plan termination liabilities imposed on multi-employer plans and seven tax bills. All this legislation has had significant impact upon private employee benefit plans.

Apart from the legislation, there has been an enormous amount of regulatory activity, which, in many cases, has had greater impact than the legislation itself.

This environment makes it extremely difficult -- in some situations, impossible -- to design and operate employee benefit plans. It takes time to design plans, and it takes time to set up appropriate administrative and support systems. It is often difficult and expensive to make plan changes. Yet employers are constantly forced to modify their plans or plan funding to keep up with current legal requirements. Moreover, because plan provisions and modifications must be communicated to employees, they, too, suffer from the confusion of constant change.

The TEFRA provision changing the rules on pension plan distributions provides a good example. The new rules made little sense to begin with and caused significant problems of compliance. Nonetheless, the changes were communicated to employees, many of whom elected to take advantage of TEFRA's grandfathering provisions. With the Deficit Reduction Act of 1984, all these TEFRA rules have been repealed. As a result, we now have another round of plan amendments and communication with employees.

Congress and the Administration must develop a thoughtful, coordinated policy that employers and employees can rely on in the future. There is no need for almost annual change in employee benefit law. The current situation is frustrating and self-defeating. We urge Congress to address this issue and come forth with a meaningful and stable policy that will exist for a reasonable period of time.

Administrative Burdens Should Be Avoided

The administrative burdens imposed by law and by regulation are a matter of major concern for private employee benefit plans. The time and cost devoted to compliance have grown tremendously -- and, with the Deficit Reduction Act of 1984, are likely to grow still more. This is due in large part to the complexity of the law itself and the supporting regulations.

Clearly, administrative burdens can be counterproductive. Before ERISA, when legal compliance was easy for most employers, we saw significant growth in private plans and in the funding of promised benefits. Following the passage of ERISA, we saw a substantial decline in new plan formation and a shift of emphasis to the defined contribution approach to providing pension benefits. In addition, by imposing minimum standards, ERISA caused the institutionalization of these minimums in many situations, with the result that benefits were often cut back to the minimum. In our judgment, the requirements of TEFRA and DEFRA will result in less liberal plan provisions, as well as further plan terminations.

Hundreds of examples could be given of the cumbersome and burdensome requirements imposed on private plans. Two should suffice to make the point:

- ERISA requires vesting after a reasonable period of service. The law includes a provision to the effect that 1,000 hours of service constitutes a full year for this purpose -- a reasonable concept for handling a partial year of service. In its compliance regulations, however, the Department of Labor required all employers to count all hours of service worked by all employees -- notwithstanding the fact that millions of employees are not required to and do not provide their employers with detailed records of time worked. After much time (and after many employers had incurred substantial administrative costs in trying to comply with this requirement), the Department relaxed its position and now permits other ways of determining service. In doing so, though, the Department found it necessary to use more than 42,000 words to define what constitutes a "year of service" -- hardly a complicated concept until caught up in the regulatory process.

- An employer who submits a plan (or plan amendment) to the Internal Revenue Service for a determination letter must notify all employees of the submission to give them an opportunity to contest the request. This requirement implies an adversarial relationship and is offensive to many employers. Moreover, it interferes with timing, often requires the employer to divulge a plan change before it can or should be communicated to employees, is almost always confusing and, to the best of our knowledge, serves no useful purpose. We would be interested in knowing how many employees have responded to this notification and have taken action to intervene in the plan qualification process.

We have made this comment several times, but it is worth repeating: Requirements that inhibit employers and that create unnecessary and difficult burdens will not have a positive effect on private plan formation and expansion. Such requirements lead to plan curtailment and abandonment. The real losers then are the nonmanagement employees. And because they are the major beneficiaries of the private system, their losses should be of particular concern to the Congress. We are traveling down the road of more and more regulation. Necessary regulation should be as efficient as possible, and should avoid waste and redundancy. Administrative requirements should be reevaluated regularly and, unless they are meaningful, dispensed with promptly.

Concluding Comments

The Subcommittee, in its press release of June 4, 1984, solicited testimony on various issues relating to employee benefits and identified six specific areas of interest. We believe that our comments have touched upon all of these areas, but we should like to make some brief observations on each point:

(1) Should the tax law encourage employers to provide fringe benefits; and if so, which benefits or services should be encouraged and what type and level of tax incentive is appropriate?

In our judgment, tax laws <u>should</u> encourage employers to provide these benefits -- at least those plans that provide economic security against the major hazards faced by low- to middle-income employees. Thus, we favor the support of retirement, death, disability and medical expense plans. However, we see no compelling reasons for tax law to subsidize such other, less important plans as group prepaid legal benefits or educational expense reimbursement. It is difficult to quantify the appropriate type or level of tax incentive; this depends upon the type of benefit involved and the economic climate in which we live.

(2) What conditions or restrictions are appropriate on tax incentives to encourage employers to provide fringe benefits?

We believe that the answer to this question also depends upon the type of plan involved. For benefit-oriented plans, any necessary limitation should apply to the benefits provided; otherwise, it should apply to the level of contributions involved. Medical benefits are a good example. Medical plans are benefit-oriented, and any limitation should apply to the benefits provided, not to the cost.

(3) Are the existing rules concerning fringe benefits sufficient to ensure that all employees benefit fairly from the tax incentives?

In our judgment, the existing rules appear to be sufficient. In some respects, as we have pointed out, the rules may be unnecessarily rigid and thus counterproductive.

(4) Are the existing tax incentives for benefits such as health care, life insurance, day care, educational assistance, and cafeteria plans effective in encouraging employers to provide these benefits to a broad cross section of employees at a lower total cost than if the Government provided the benefits directly, if employers provided the benefits on a taxable basis, or if employees purchased these benefits on their own?

We believe that the most cost-efficient way of delivering employee benefits is through the current system and with the current tax incentives. However, we want to reiterate that the efficiency of the private system is vulnerable to excessive and unwarranted regulation and restrictions. For example, the growth of cafeteria plans has been hampered by the Internal Revenue Service position -- one that does not seem to be supported by the original legislation. Similarly, the additional regulatory burden imposed by the Deficit Reduction Act of 1984 is likely to have a negative effect on plan formation and expansion.

(5) How will tax laws that encourage employers to provide fringe benefits affect compensation planning?

We believe that such laws can have a positive effect on compensation planning. However, because of its frequency, recent legislative activity is having just the opposite effect. Employers are increasingly reluctant to plan ahead or to commit themselves to long-term obligations. Most find themselves in a reactive mode and are simply trying to cope with almost constant change.

(6) Will tax incentives for employer-provided fringe benefits affect potential employees' choice of employment?

We think that the presence or level of fringe benefits has very little to do with an employee's choice of a place of employment, at least until after age 40 or 50. Direct pay is still the most significant consideration for a majority of those seeking work.

* * * * * * * *

We again would like to express our thanks for being permitted to appear before your Subcommittee. We would like to offer our assistance to you in your work in any way that we can. We strongly believe in the need for the private system to provide employee benefits and in the system's integrity. We are committed to supporting its continued growth and expansion.

Senator PACKWOOD. As to your comment about stability, it is not limited to employee benefits. That is the complaint you get from almost everyone in this country about the Tax Code. It used to be we passed a tax reform bill every 10 or 15 years or so. At the time I came to the Senate we were doing it every 3 or 4 years. Now we do it every year. It always has the name "reform" on it.

Senator Long was once going to introduce a bill that would prohibit the use of the word "reform" in any tax bill. [Laughter.]

Now we do it so frequently that the Treasury Department and the Internal Revenue Service often cannot issue regulations before we have changed the law that they were going to issue the regulations under. We've changed the law before you knew what the new law was.

Mr. ALLEN. Yes, sir. That's true.

Senator PACKWOOD. Probably it's a benefit in that sense; maybe the law was never any good anyway, so it's just as well you never knew what it was before we changed it.

Mr. Beadle.

STATEMENT OF CARSON E. BEADLE, MANAGING DIRECTOR, WILLIAM M. MERCER-MEIDINGER, INC., NEW YORK, NY

Mr. BEADLE. Thank you, Senator Packwood.

We have held for some time that a review of tax policy would be helpful in shaping the provisions and regulations that best serve the social and revenue needs of the country.

Mercer-Meidinger has, for example, just conducted a survey of several hundred chief executive officers to determine the importance of tax preferences in the sponsorship of benefit plans by the private sector. We were also interested in how current practices might change if these tax preferences were to be eliminated. The results are still coming in, but let me share with you some of the early findings, based on about 400 employer responses received by last weekend.

Senior officers had this to say about tax preference for benefits:

Eighty-seven percent believe that tax preferences for benefit programs should remain; 78 percent believe that most U.S. companies will cut back on benefits if current tax preferences are ended; 72 percent believe that employees would not purchase replacement insurance to make up for reduced company benefits even if their salaries were increased to make that possible; 85 percent believe that employees would not invest money for their retirement under the same conditions.

Ninety percent of these CEO's believe that eliminating tax preferences would negatively affect the health and welfare of workers and their families, and 87 percent believe this would negatively affect the economic security of retired workers.

Senator PACKWOOD. Let me interrupt you to ask you a question. I asked this yesterday and I'll mention it over and over throughout this discussion over the next year:

Why don't these CEO's ever call us up about these particular issues?

Mr. BEADLE. I think that is a very fair question.

Senator PACKWOOD. They called us on 10-5-3. I have had phone calls from two of the presidents of two of the major textile companies in this country. It was over a relatively minor bill, a textile labeling bill about "Made in the United States" but they never call about these issues.

Mr. BEADLE. I think we have a fundamental issue here, and that is that we seem to be wrestling with whether the country wants to do things in a private-sector way or in a socialized way. I don't think that this has been drawn to the attention of the CEO's of this Nation. I think what they are addressing at the moment is whether the tax laws that we have properly support the private sector, and people who are experts in that are appearing and dealing with that issue.

The social issue has not really been brought to the forefront yet and their interest in it rallied round.

Senator PACKWOOD. What I sense is what I said at the close of the hearing yesterday. I said, "I'll make you a bet. If by chance Vice President Mondale was elected, and if by chance his tax program included a 5-percent increase in the corporate income tax, every Member of this Congress would get dozens of phone calls from the CEO's of the major corporations of this country that this tax is outlandish, "that it is immoral", "that it is wrong". We never get phone calls about "are we going to remove the tax status of health benefits, or are we going to put a cap on them?" There you get the trade associations, the health insurance industry, the insurance companies, the pension plan managers, personnel managers, but never CEO's.

Mr. BEADLE. I think we have a tenuous situation in this country. There are many employers for whom it would be an advantage not to have to worry about these benefit plans.

Senator PACKWOOD. Except then they would be taxed to pay for the Government to do it.

Mr. BEADLE. That's right, but that shifts us, then, into whether the country ought to provide health benefits and insurance security in a private enterprise way or in a socialized way.

Senator PACKWOOD. I am curious about the fact why these CEO's don't want it done by the Government. If they really thought it through and thought, "they are going to levy a 5-percent employer payroll tax on me to provide for day care and health benfits for my employees," they would realize that in the long run it is going to be cheaper for the company to do it than to pay the tax for the Government to do it.

Mr. BEADLE. That's the macropicture; when you get down to each of them as individual organizations, I think we get then into the philosophical question—on the one hand, should it be Government? On the other hand, if it is to be private, what do we need to make it work?

Do I get a couple of extra minutes?

Senator PACKWOOD. Yes. I am going to be the one who delays these hearings. I will quit asking any more questions. [Laughter.]

Mr. BEADLE. Continuing with the survey, just a couple of more findings:

Seventy-three percent of the CEO's believe that if employers cut back on benefits, pressure will be put on the Government to increase Social Security and/or welfare benefits.

Now, the CEOs are concerned about the deficit. Two-thirds say it is crucial that it be reduced, and another 32 percent say it is "important." But 81 percent disagree that eliminating tax preferences for benefits would be a sensible approach to increasing revenues and reducing the Federal deficit.

The present system, with little more incentive than a favorable tax climate, has been awesome in its ability to protect upward of 150 million Americans and their families against some forms of medical costs and loss of income.

Our survey bears out that, at least in the view of employers, this tax climate is essential to the preservation of private sector programs as we know them.

Other features of the present system are impressive—the breadth of protection has been wide-ranging. The ability to respond in a timely way to the changing needs of the work force has been remarkable; the high degree of freedom of choice has been provided to employees while preserving a minimum base of protection.

The point of these illustrations is that the present employee benefit system has addressed a number of vital concerns while preserving a high degree of freedom of choice and flexibility.

The private sector has been shouldering the responsibility for arranging for the income security of their employees. If we are to avoid a drift toward the social approach, we must be concerned with what it takes to maintain that interest, or, conversely, what actions might discourage it and to what extent—the point you made this morning about education.

The two factors that have given America its private sector solution to ensuring personal financial security for employees and their families are, first, a stable environment and second, a climate of encouragement which the favorable tax treatment has provided. It takes time to design, approve, and implement benefit changes.

Once announced, employees want a sense of security they can count on. Rapid or retroactive legislation of interpretations make it very difficult to accomplish these objectives.

Regarding the tax climate, we believe that favorable tax treatment has set benefits apart from cash compensation, and in so doing has created a subtle pressure to improve the financial security of the Nation's people. In spite of the attraction that direct spendable cash has for most of us, under this system, employers and unions alike have looked upon benefits specially and the growth of plans to provide personal financial security has been outstanding.

For the vast majority of employees and their families, this growth in income security has been reasonable and self-limiting.

Senator PACKWOOD. I've got to ask you to wind down now; I didn't take up that much time.

Mr. BEADLE. Yes? Well, I had it down to 4:58. [Laughter.]

I will just wind up. I do think in the health care area we have seen an interesting example of how our system adjusts. Hundreds of ideas are being pursued by employers, insurers, and providers to find a better way to deliver quality health services at reasonable cost without Government intervention.

The final point I would make: The tax advantages that spawned the private-sector approach to meeting the income security needs of this Nation so impressively need to remain intact. Those employers that are the architects of redesign need to be encouraged to pursue improvements. We believe this will be encouraged best through a stable legislative and taxation environment.

I think that the research you are doing with your committee is great; we applaud your efforts

Senator PACKWOOD. Thank you.

Ms. Koralik.

[Mr. Beadle's written testimony follows:]

CONGRESS OF THE UNITED STATES
UNITED STATES SENATE
COMMITTEE ON FINANCE
Subcommittee on Taxation and Debt Management

Hearings on

FRINGE BENEFITS

July 27, 1984

Statement
by
Carson E. Beadle
Managing Director
William M. Mercer-Meidinger, Incorporated
1211 Avenue of the Americas
New York, NY 10036
212-997-7004

39-706 O - 85 - 26

Mr. Chairman and distinguished members of the Subcommittee:

I am Carson E. Beadle, Managing Director of William M. Mercer-Meidinger, Incorporated, a benefits and compensation consulting firm of some 2,700 employees, including over 360 actuaries, and operating in forty cities in the United States as well as in major cities around the world. I have been in the employee benefits field for thirty years and had the privilege of working with employers, joint union management trusts, medical societies and governments.

Over these years my associates and I have witnessed a great deal of change and growth in fringe benefits that provide income security to employees and their families and I hope my comments today will provide a useful perspective based on this experience.

It is fitting, Mr. Chairman, that you and your Subcommittee are prepared to examine the broad implications of providing fringe benefits income security to the nation at a time when the tax structure, which has effected the development of benefit plans, is under review. The Subcommittee has posed excellent questions that deserve examination in depth and my company is committed to lending assistance to you in whatever ways may be helpful to you.

Mercer-Meidinger has just conducted a survey of several hundred Chief Executive Officers to determine the importance of tax preferences in the sponsorship of benefit plans by the private sector. We were also interested in how current practices might change if these tax preferences were to be eliminated.

Let me share with you the preliminary findings from this survey. I believe, Senator Packwood, that your staff has a copy of the survey questionnaire and we would be pleased to provide additional copies. The following results are based on about 400 employer responses received by last weekend. Responses are still being received. This is what these senior officers had to say about tax preferences for benefits:

- 87% of the people responding believe that the current policy of providing tax preferences for benefit programs should remain intact

- 78% believe that the majority of U. S. companies will cut back on benefits if the tax preferences now afforded to employer-sponsored benefits were ended

- 72% of these C.E.O.'s believe that employees would not purchase replacement insurance to make up for reduced company benefits, even if their salaries were increased to make that possible. 85% believe that employees would not invest money for their retirement under the same conditions

- 90% believe that eliminating tax preferences for benefits would have a negative effect on the health and welfare of workers and their families

- 87% of the respondents believe that eliminating tax preferences for benefits would have a negative effect on the economic security of retired workers

- 73% believe that if employers cut back on benefits, pressure will be put on the government to increase Social Security and/or Welfare benefits

- CEO's are concerned about the deficit -- two-thirds say it is "crucial" that it be reduced and another 32% say it is "important". But 81% disagree that eliminating tax preferences for benefits would be a "sensible approach to increasing revenues and reducing the federal deficit".

The present system with little more incentive than a favorable tax climate has been awesome in its ability to provide financial security to upwards of 150 million Americans and their families facing large medical expenses or loss of income due to death, disability or retirement. This survey bears out that at least in the view of employers, this tax climate is essential to the preservation of private sector programs as we know them.

There are other features in the present system that are impressive:

- The breadth of protection that has been made available has been wide-ranging from medical, dental, and vision care, to continuing income to employees who become disabled or after they retire as well as providing important benefits to protect the lifestyle of the dependents after the death of a breadwinner

- A remarkable ability to respond in a timely way to the changing needs of the workforce has been demonstrated. Examples include the currently emerging need for dependent care arrangements, and the ability of the system to meet the special needs of each community and each group of workers

- A high degree of freedom of choice has been provided to employees while preserving a minimum base of protection.

The point of these illustrations is that the present employee benefits system has addressed a number of vital concerns while preserving a high degree of freedom of choice and flexibility.

The private sector has been shouldering the responsibility for arranging for the income security of their employees and we should be concerned with what it might take to maintain that interest, or conversely, what actions might discourage it and to what extent.

The two factors that have given America its private sector solution to ensuring personal financial security for employees and their families are first, a stable environment and second, a climate of encouragement which the favorable tax treatment has provided.

By "stable environment" we mean one in which employers and unions can take a sufficiently long-term view in addressing benefits issues. For example, any change in the needs of employees requires study -- issues such as the increased number of women or single parents in the workforce, or new forms of healthcare, or healthcare costs that are rising more rapidly than the system can afford. The role of collective bargaining, where this applies, must be addressed. Then there are such time-consuming issues as pricing, getting approvals, communications to employees, development of administrative systems, and actual participation of employees in the education and counseling this requires, if it is to be done properly and fairly.

Rapid or retroactive legislation or interpretations intimidate the planners and reduce the level of constructive experimentation. The process for dealing with change needs to be more sympathetic to the practical problems of employers and unions in developing benefit programs and in communicating these with a consistency that gives employees confidence.

Regarding the tax climate, we believe that favorable tax treatment has set benefits apart from cash compensation and in so doing has created a subtle pressure to improve the financial security of the nation's people in spite of the attraction that direct spendable cash has for most of us.

To those who would say that this view gives too much weight to the role played by special tax treatment we would suggest that under this system employers and unions alike have looked upon benefits specially, and the growth of plans to provide personal financial security has been outstanding. For the vast majority of employees and their families, this growth in income security has also been reasonable and self-limiting.

Regardless of the fact that further benefit increases can be provided "tax free", there is a level at which employees and employers begin to believe that benefits are taking too high a proportion of the compensation package. When this occurs we begin to see a slowdown in benefit increases or sometimes even a rollback in benefits, and a search for greater efficiency and cost effectiveness in benefits design, funding, investment and delivery particularly in the area of health services. This became evident during the recent recession, when the private system in this country responded quickly to the changing economic environment.

The private sector sponsorship of benefits, with the guidance and support of the legislators, has produced pension programs in which pension commitments are funded, unlike pension commitments under government-sponsored programs such as Social Security. This funding has in turn contributed significantly to the capital resources of the nation. The private sector was also on its way to securing the financial future of its medical plans for retiring persons until the Deficit Reduction Act slowed this trend.

The area of healthcare costs is a timely example of the outstanding power of the system this country has created. Hundreds of ideas are being developed and tested by a wide range of employers, insurers, and providers, all seeking to find the best methods of delivering quality health services at reasonable prices, eliminating where possible the excessive and questionable use of services without limiting the individual's right to proper care. In other countries, governments tend to design and impose constraints to limit healthcare costs.

The tax advantages that spawned the private sector approach to meeting the income security needs of this nation so impressively, need to remain intact. Those employers that are the architects of redesign need to be encouraged to pursue improvements. We believe this will be encouraged best through a stable legislative and taxation environment.

We are convinced that tax preferences have and will continue to play a significant role in encouraging employers and employees alike to consider their needs and to assign some of their spendable cash to prepare for their own income security.

Thoughtful fine-tuning of tax provisions and interpretations to minimize abuses will benefit us all. The continuation of tax preferences will provide the encouragement and stability to the private sector to continue to take care of its own employees and their families.

The research undertaken by this Committee is in our view an important step in this process and we applaud your interest and your efforts.

STATEMENT OF SUSAN KORALIK, PARTNER, HEWITT ASSOCIATES, LINCOLNSHIRE, IL

Ms. KORALIK. Thank you.

Let me shorten my comments by just saying that I agree with my colleagues. Our perspective is that the debate over the appropriateness of employee benefits has arisen because of the concern that the need is still there for certain employee benefits, but perhaps employers have gone too far. And that's why we think a lot of people are saying that perhaps we should be cutting back on benefits.

We would like to comment on that proposal based on some data that we have looked at. What we have found is that most of the growth in employer payments for medical care, which is one of the most expensive benefit areas, has been due to factors other than benefit improvements.

As we looked at private health insurance premiums in the United States, they rose from $22 billion in 1972 to $84 billion in 1982. So they just about quadrupled in 10 years. But during that same 10-year period we looked at the value of benefits provided to employees in the medical area, using an actuarial study that we do of about 100 major employers. We found that benefit improvements in the medical area were only about 9 percent of the 1972 values. That suggests that if we reduce current premiums by that 9 percent, premiums for the 1972 benefits would already be at $77 million. So the premiums are going up by about a factor of 3.5 in the 10-year period without considering any benefit improvements.

The increase in premiums, therefore, has to be due to the increased number of covered individuals, possibly improvements in individual insured contracts, and of course the rising cost of health care.

Beyond that, we also recognized that employers are actually trying to cut back on their benefits at this point. We recently concluded a survey of 1,200 major employers, and what we found was that in 1982, 67 percent of those employers were providing for 100 percent of the cost of reasonable and customary hospital charges. By 1984, just 2 years later, that 67 percent had dropped to 42 percent who were willing to pay for 100 percent of the costs. We saw similar shifts in a decrease in payments for surgical benefits, increases in deductibles, and other changes.

We have also seen employers trying to encourage employees to be better consumers of health care. Twenty-eight percent of the companies that we surveyed mandate now that employees get a second opinion before having certain surgical procedures. Thirteen percent are covering hospices, trying to encourage people to get into alternate forms of health care. Thirty-nine percent cover ambulatory surgery.

So we have found that employers are making a very significant effort to control their costs while still providing for the financial security of their employees.

The conclusions that we draw from this are three:

First, that the need for protection against these financial hazards hasn't changed, but the growth in the level of benefits has leveled off or has even been cut back.

Second, the future benefit growth will come from three areas—first, the increase in pay levels and medical costs; second, the spread of coverage to more people; and, third, the addition of new benefits to address new needs such as dependent care.

Our third conclusion is that the employer-sponsored programs are the most effective means of spreading this coverage to a large proportion of the population.

Thank you.

Senator PACKWOOD. Mr. Garrett.

[Ms. Koralik's written testimony follows:]

Testimony of Susan Koralik,
Partner, Hewitt Associates
July 27, 1984

Good morning. My name is Susan Koralik. I'm a partner with Hewitt Associates, a consulting firm specializing in employee benefits and compensation. Since the company was founded in 1940 we have worked with over 3,500 employers and our research staff has routinely collected and analyzed benefit data to identify common practice and trends. Based on conclusions reached from our surveys, we would like to comment on the appropriateness of providing tax-favored status for employee benefits in 1984 and the future.

Let me start with our understanding of the original purposes behind granting tax-favored status to benefits. The government saw two needs.

1. Assets should be set aside to provide a source of income for the elderly. A retirement plan could prevent dependency on welfare systems, and provide a supplement to Social Security to permit a more realistic replacement of preretirement living standards.

2. Individuals should be protected against the financial hazards of unexpected expenses in the family due to health problems, disabilities and death. By encouraging the pooling of these risks, the individuals can be protected without depending on welfare.

These needs were addressed by giving a tax break to the employee--the value of these benefits would be tax deferred or nontaxable. And we note that the decision was made to give the greatest tax breaks to employer-sponsored plans. We assume this was justified on the basis that as the employer of many individuals, an organization could negotiate the best financial arrangement and group pooling for its employees.

Another advantage for granting tax breaks for employer-sponsored plans is the ability to enforce nondiscrimination requirements for the operation of the plans. Without the inducement of tax deferment, the government could not insist on broad coverage and nondiscriminatory allocation of funds among employees. We currently have nondiscrimination requirements for a wide range of benefits: pension, profit sharing, 401(k) plans, group benefits included in cafeteria plans, and group term life insurance. All of these plans must be available to a broad cross section of employees, and employer contributions to the programs must be allocated in a manner that does not favor the highly-paid. Contrast that with IRA's, which are available to all individuals but are not subject to any nondiscrimination requirements. In 1982, only 18.9% of the IRA's in place were for people earning under $20,000. These accounts are by far most prevalent among middle-income and highly-paid people.

Beyond enforcing nondiscrimination, the tax breaks given to employer-sponsored plans had the desired effect of encouraging employees to seek and accept benefits as a form of compensation. The issue for today is, have they gone too far? Benefit programs have become very popular with employees and have gradually grown as a proportion of total compensation. Unfortunately, at the same time, we have a second issue of an already large and growing federal deficit. This prompts two questions:

1. If we remove tax incentives, will employees still want benefits and will employers still provide them?

2. Should we cut back on benefits to close the budget gap?

The elasticity of the demand for benefits is difficult to predict. We would anticipate that the demand would fall off to some degree if the tax breaks were cut. However, the need to pool risks would maintain some of the demand among employees for insurance type benefits. And the need to provide an atmosphere of security and to create an incentive for older employees to retire would maintain employer interest in some group programs.

But should we cut back? Let me focus on the two benefit areas with the greatest costs--medical and retirement.

As we look at the growth in employer expenditures for medical benefits we find that most of the growth is due to factors other than benefit improvements. Total private health insurance premiums have grown from $22 billion in 1972 to $84 billion in 1982. That is a 382% increase. But, the growth due to benefit improvements as measured by Benefit Index™, an actuarial study of the benefits of about 100 major employers, was only about 9% during this period. If we reduce our total premiums of $84 billion by 9%, total premiums would still be $77 billion. That suggests that we would have experienced about a 350% increase in premiums paid due to an increase in the number of covered individuals, improvements in individual insurance, and the rising cost of health care. Therefore, the erosion of the tax base is not due so much to the expansion of benefits but more so to the rising cost of standing still.

It should also be noted that employers are now trying to curb the growth in medical insurance costs by cutting back on medical benefits. A Hewitt Associates survey of about 1,200 employers indicates that in 1982, 67% reimbursed employees for 100% of reasonable and customary hospital charges. By 1984, that percentage had dropped to 42% of the companies. And activity among our clients indicates that if we do the survey again in two years, we will see another significant drop.

Employers are also trying to control their costs by encouraging employees to be better consumers. For example, 28% of the employers now mandate that employees get a second opinion before going ahead with certain surgical procedures. A growing percentage of employers are encouraging alternative forms of health care such as home health care, ambulatory surgery and HMO's. Employers are trying to control their medical costs while providing for the financial security of employees.

The need for retirement benefits has not gone away either. As the Social Security system has matured, benefits for the average age 65 retiree have been decreased from 44% of pay in 1977 and are expected to level out at around 38% of pay by 1985. This hardly suggests that it is time to discourage action by the private sector.

Should we discourage advance funding of these benefits? We believe the answer is no. If anything, because of the potential rekindling of inflation and the growth of liabilities, it is appropriate to encourage employers to fund as much as possible for their employees' security.

Here again we might note that we have not seen continued expansion in the value of pension benefits provided by major employers. Using our Benefit Index survey results, we saw a growth in the value of the plans of about 6% in the mid-1970's to add the vesting requirements and death benefits mandated by ERISA. Then, we saw an increase in value in the late 70's and early 80's as Social Security benefits fell and integrated pensions made up part of the difference. But our surveys indicate that the average accrual rate in pension plans of 1.6% of final average pay for every year of service has not changed in the last several years.

Therefore, the growth in pension funding is due to the increased numbers of covered participants, more rapid vesting, better benefits for early retirement, better benefits for survivors of deceased participants, and a partial balancing of the decrease in government provided benefits.

Conclusions

Looking at current data and the trends we have been able to identify over the years, we can draw some conclusions about the appropriateness of tax incentives for benefits.

1. The need for financial protection for unexpected expenses and savings for retirement has not changed. But growth in the proportion of the benefits provided in these areas has leveled off. If anything, employers are trying to cut back.

2. From now on, benefit growth and the attendant loss of currently taxable income will be dependent on:

   -- Rises in pay levels and the medical costs that benefits provide protection against.

   -- The spread of benefits to greater numbers of people.

   -- The addition of some new benefits, such as dependent care.

3. The great advantage in using employer-sponsored plans is their tremendous effectiveness in spreading protection to everyone. One recent example of this effect is the 401(k) plan. Hundreds of employers have implemented these tax-deferred savings plans and have put great effort into making sure that lower-paid employees participate in them. The tax-favored status of benefits is a powerful tool for ensuring that all employed individuals have the protection they need.

Getting back to the issue of whether the tax incentives for employee benefits should be cut back, we reach this recommendation. Congress must recognize that we are not dealing with a short-term problem. The need for benefits is real and is ongoing. We should not tamper with this long-term issue to deal with short-term deficit problems. On the other hand, if current tax incentives extend beyond areas that are considered legitimate needs, changes should be made. But we must act responsibly and consider the needs of the individual as well as the government.

STATEMENT OF HARPER L. GARRETT, JR., VICE PRESIDENT, ALEXANDER & ALEXANDER, INC., NEW YORK, NY

Mr. GARRETT. Thank you for giving me the opportunity to present our views on the important questions before this subcommittee.

My name is Harper Garrett. I am vice president, director of professional services in the human resources management division of Alexander & Alexander, one of the country's oldest and largest consulting firms, advising employers on the design and funding of benefit plans.

Since 1934 we have been helping employers install benefit plans to protect their employees against the economic hazards of depth, disability and illness. In 1949 we expanded our services to include the design and implementation of retirement and capital accumulation plans.

Now, I cite this historical information simply to call the subcommittee's attention to the fact that what were called fringe benefits in 1934 and 1949 have now grown inexorably into personal economic security programs for American workers As a matter of fact, it seems somewhat incongruous to refer to these important programs as fringe benefits, in light of the historical and continuing growth and the cost, the number of employees covered, the amounts and kinds of benefits provided, and the still evolving types of plans that are made available to more and more working Americans.

In no small part, this continuing expansion is due to the tax incentives which have encouraged and supported these programs.

In response to this subcommittee's question No. 1: Should the tax law encourage employers to provide fringe benefits? We say yes.

What type and level of tax incentives are appropriate? We recognize that the focus of this hearing is what ERISA calls welfare plans and not on programs to provide retirement benefits. Nonetheless, it might be instructive to consider very briefly the type of tax incentives which stimulated the growth and development of retirement plan programs.

Briefly, these are that employer contributions to the cost of the plan are tax-deductible within reasonable limits. Investment earnings on funds set aside to secure the payment of these benefits are not taxed until paid in the form of benefits. The benefits are not taxed until received, and reasonable integration or coordination rules permit recognition of existence and costs of other employer-financed benefits such as Social Security.

As a result of these incentives, employers have been willing over the past 40 years or so to contribute increasing amounts to retirement plans.

I submit that the same type of tax incentives that led to the continuing development of economic security for retirees are equally appropriate for the many other employer-sponsored benefits that sustain employees throughout their working careers.

The existing tax incentives for these other employee benefits should be continued and expanded, not reviewed with an eye toward curtailment.

Looking at whether the tax laws should encourage employers to provide fringe benefits, I think it is important to also consider some of the other reasons for employer involvement. One of these is, the employer has the ability to establish plans that can offer advantages on a group basis that would not be available to employees attempting to obtain these benefits individually. Such advantages are significantly lower administrative expenses, more liberal participation requirements, and a wider variety of both types and amounts of benefits tailored to the needs of the specific group of employees.

Tax incentives have unquestionably helped in the development of private pension plans and have taken pressure off of Social Security. I believe that continued support of other tax-favored employee benefits fulfills equally important social goals and takes pressure off not only current Government programs but obviates the need for other Government programs that would be required in the absence of private employee benefit plans.

In short, sir, I believe that Congress has been pursuing the correct course when encouraging private sector employee benefits and should continue to do so.

I thank you very much for the opportunity to express our views.

Senator PACKWOOD. Thank you.

[Mr. Garrett's written testimony follows:]

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SUBMITTED AS PART OF THE RECORD OF THE HEARING ON
EMPLOYEE FRINGE BENEFITS
HELD ON JULY 26, 27 and 30 BY
THE UNITED STATES SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

BY
HARPER L. GARRETT, JR.
VICE PRESIDENT AND DIRECTOR OF PROFESSIONAL SERVICES
ALEXANDER & ALEXANDER INC.

During the coming year, it is quite likely that suggestions will be made, or proposals put forth, to change the present Social Security integration rules. Ever since the IRS issued detailed regulations describing the permissible rules for integrating private pension plans with Social Security in Revenue Ruling 71-446, these rules have come under criticism from time to time. Thus, it is entirely possible that they will periodically be subject to such discussion in the future.

Because of this, I would like to speak out in defense of the concept of integration. Basically, integration refers to the coordination of an employee pension plan benefit with the retirement benefits from Social Security. Since these two sources of retirement income are provided for, at least in part, by the employer, it is reasonable to consider them in combination when defining retirement income objectives.

In the private sector, the retirement income objective is generally expressed as the amount of income that is adequate to maintain the retired worker and his dependents on a standard of living reasonably consistent with that which they enjoyed during their pre-retirement years. This normally takes account of the combined benefits payable from the private pension plan and payable from Social Security to the individual. Such amounts are generally expressed in terms of what are known as replacement ratios, i.e., the percentage of retirement benefits including Social Security as compared to the pre-retirement income.

Replacement ratios are generally less than 100% for fairly obvious reasons, such as:

1. Taxes of the retired employee are less than those of an active employee.

2. Certain expenses associated with employment no longer exist.

3. The cost of supporting children has generally ceased.

4. Mortgage payments have generally ceased.

Therefore typical replacement ratio objectives in corporate plans range from about 50%-60% for higher paid employees up to about 70%-80% for lower paid employees. These replacement ratios are generally targeted toward a "full service employee", i.e., one who has rendered perhaps 30 to 35 years of service with one employer.

You will note that in computing replacement ratios, the individual's personal savings are generally not taken into account. Most of us need only look at our own personal cumulative savings to understand why this is so. Briefly, one's personal savings would normally not provide a very substantial amount of retirement income when converted into an annuity stream. Any personal savings may simply be thought of as a supplement to the retirement income.

Under the current regulations, there are several permissible ways to integrate a pension plan with Social Security. However, since by far the most prevalent method used is the "offset" method (see Report by the General Accounting Office on Features of Nonfederal Retirement Programs, GAO/OCG-84-2, June 26, 1984), I would like to concentrate my remarks on this approach. Under the offset approach, an amount equal to a portion of an employee's Social Security benefit is deducted from the benefits that would otherwise be payable under the private plan's pension formula. In view of the current regulations, most corporate plans utilizing this approach generally end up offsetting somewhere between 50%-60% of the individual's Social Security benefit.

Let's look at an example of offset integration, since it will serve to illustrate the underlying concept of all Social Security integration. First, let's look at the benefits provided by Social Security. Note that Social Security was specifically designed to replace a higher percentage of income at the lower salary levels than at the higher salary levels. To illustrate this, I have shown replacement ratios for a retiree in 1984 ranging from 50% at $10,000 to 12% at $70,000 (see Table 1). Note the very strong tilt in favor of those with lower earnings.

Next, let's consider the actual replacement ratios under a typical private plan which is integrated with Social Security and also complies with IRS regulations (see Table 2). Note that this offset plan is designed to recognize the Social Security tilt in favor of lower paid employees. Therefore, when this plan's benefits are combined with Social Security benefits, the resulting total replacement ratios are actually quite close to the original 50%-80% desired replacement ratios (see Table 3).

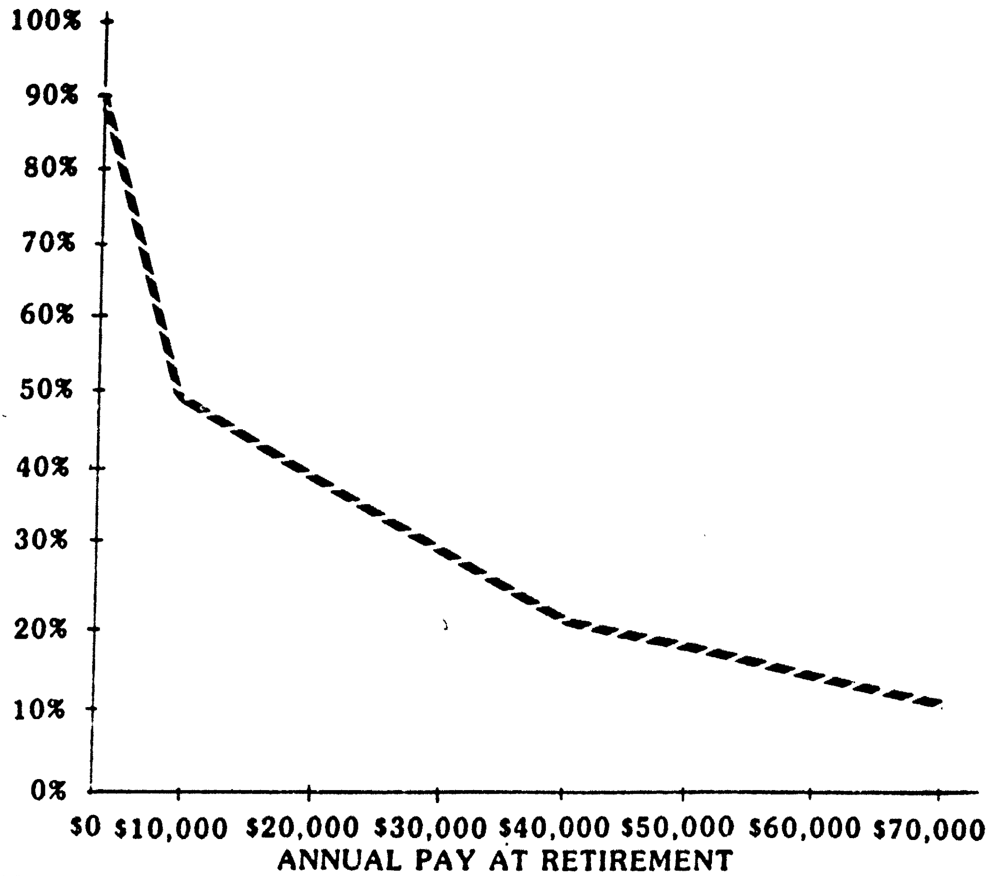
If an employer were not permitted to integrate his plan with Social Security, you can see that in order to provide adequate pensions for the higher paid, it would be necessary to overpension the lower paid (i.e., provide replacement ratios in excess of 100%, in many cases).

Such overpensioning could not be maintained over the long term. Not only does it not make sense with regard to an individual's situation, but the nation could not afford the cost of such a pension system. Instead, the bulk of pensions for higher paid participants would be gradually moved outside the framework of a qualified retirement plan, and weaker pensions would be provided inside the plan for all participants.

Tax laws must continue to allow full recognition of our universal mandatory Social Security system in the design of private sector pension plans in order to maintain good private sector pensions for the majority of employees. If any modifications to Social Security integration are contemplated, they should be restricted to a possible simplification of some of the current complexities, but in no event should the permissible offset be reduced to less than 50%. The underlying principles of Social Security integration are still valid, and any review of this topic must start with the fact that employers and employees do share equally in the payment for Social Security.

TABLE 1

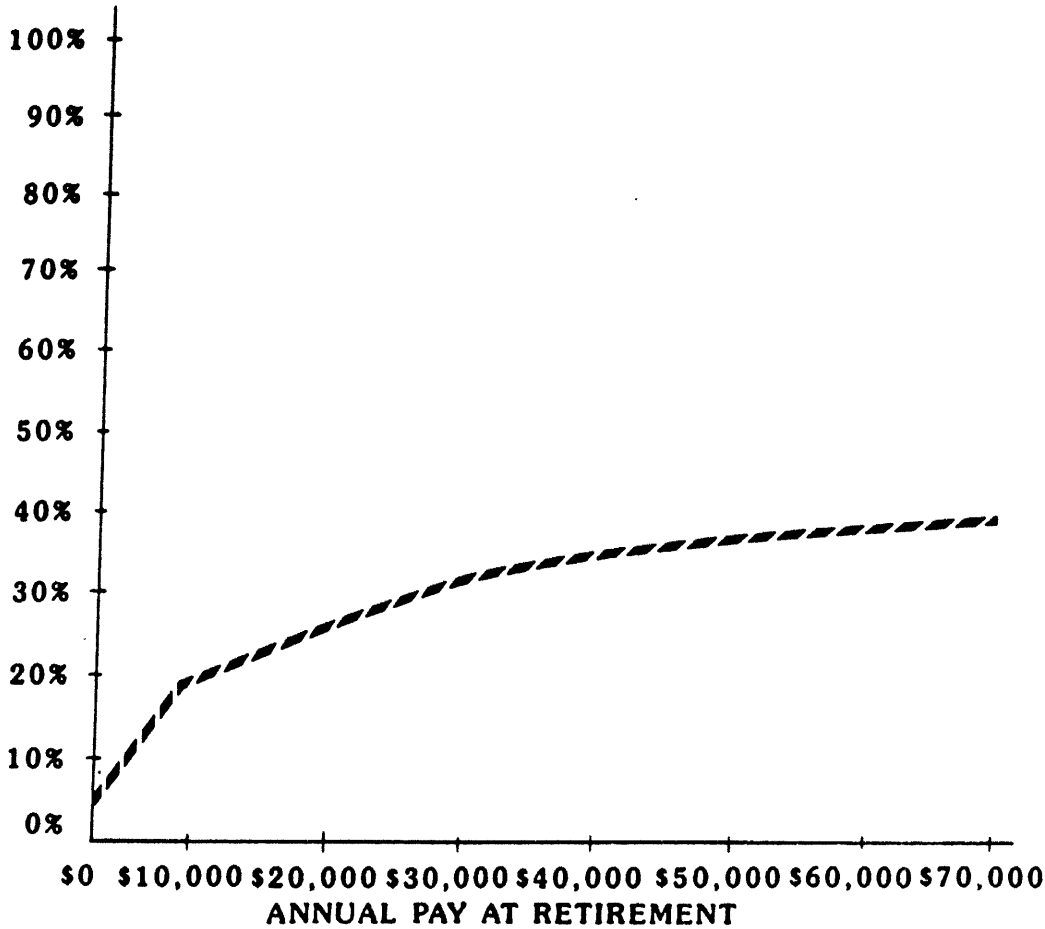
SOCIAL SECURITY REPLACEMENT RATIOS



SALARY AT AGE 65	ANNUAL PRIMARY SOCIAL SECURITY BENEFIT	REPLACEMENT RATIOS
$10,000	$5,028	50%
$30,000	$8,364	28%
$50,000	$8,436	17%

TABLE 2

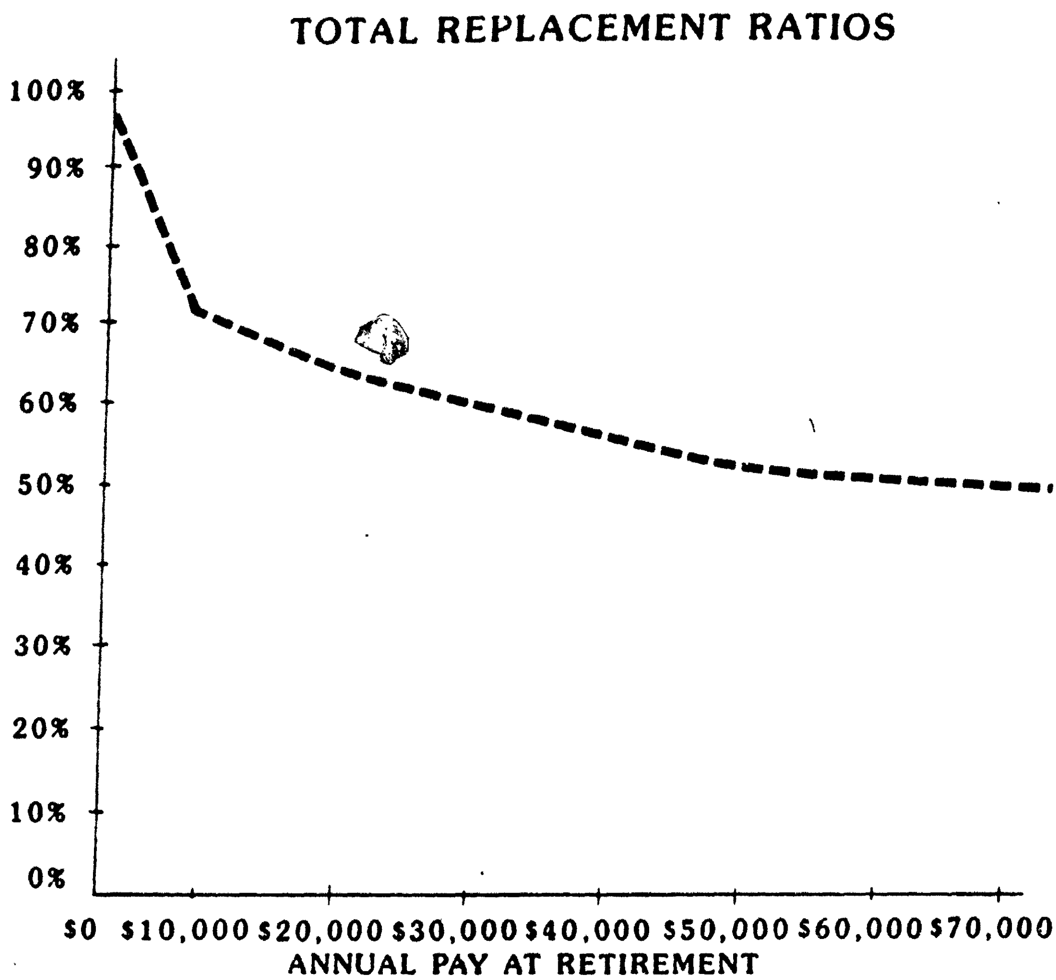
PENSION REPLACEMENT RATIOS



SALARY AT AGE 65	ANNUAL PENSION BENEFIT*	REPLACEMENT RATIOS
$10,000	$1,930	19%
$30,000	$9,151	31%
$50,000	$18,004	36%

*50% OF FINAL AVERAGE SALARY MINUS 50% OF SOCIAL SECURITY BENEFIT

TABLE 3



SALARY AT AGE 65	TOTAL RETIREMENT BENEFIT	REPLACEMENT RATIOS
$10,000	$6,958	70%
$30,000	$17,515	58%
$50,000	$26,440	53%

Senator PACKWOOD. I am glad to have Senator Durenberger with us. Dave, do you have an opening statement?

Senator DURENBERGER. Bob, just a brief comment—I know you have a long day.

First, I must, because of a longstanding interest in this subject, thank you for scheduling these 3 days of hearings and for taking on the rather difficult subject which has a whole lot of difficult-to-understand philosophy pulling it in a number of different directions.

You have an incredibly long list of so-called experts out there, and I don't know that there is anybody who is an absolute expert on this particular subject, because it seems to me we are dealing in an area in which not every employer-employee relationship is quite the same, nor are people of different ages, in different parts of the country, in different walks of economic life going to make choices in similar fashions. So you have a very disparate field out there in which to operate.

It strikes me, however, that one of the things we need to be dealing with here besides the overall issue of fairness and equity, which I see throughout Buck's statement yesterday and so forth, is the issue of what role the Tax Code ought to play in facilitating the delivery of what in many cases is considered public services.

I hear you say often in private at least—I don't know if you have said it yet in public—that it is cheaper to go this way than the Government route. And so basically we are talking in a lot of these areas about what are considered public needs and are therefore met by the delivery of public services.

But from my perspective, it strikes me that this sort of thing, as they say, can get out of hand. I am not going to lecture the room on why we get blamed for destroying the health care system in this country because we created medicare and medicaid.

I just spent a week in Minnesota going all over the State and having these doctors come up and say, "Hey, wait a minute—you are doing all the wrong things out here. The problem is 1965, and you guys, you politicians, created this giveaway program." And I listen to them very patiently, and then I go back and say, "No, the problem started—with your help—in 1954. That was the point in time at which we decided we were going to use the Tax Code to facilitate this decisionmaking process."

And in the course of using the Tax Code, both the deduction side and the exemption side, we—all of us together; these experts down here and us—brought on medicare and medicaid. But mainly what we have done is destroyed the concept of health insurance.

There isn't health insurance in this country anymore, except for farmers and small business people and a few folks that just can't afford to buy into these programs.

If you adopt the notion that insurance is protection against financial catastrophe, we have all helped to destroy that system, and out there we now have a $360 billion a year sick-care industry that's taking money away from health in order to feed this sick-care industry. It has all been very well-intentioned, and it's all very necessary. We've put things into those health plans, you know, that people wouldn't do for themselves, but in effect we haven't come to grips with some of the basic problems of the consumer's involvement in his or her health care.

So, I will be interested as we go through this process in looking at the health insurance arrangement, the pension arrangement, the child care arrangements that you care so much about, and the education arrangements you care a lot about, but trying to examine them from the perspective of what impact writing the blank check, so to speak, to do good for people they wouldn't otherwise do for themselves, what impact that has on the ability of all of us to constrain the rising costs in child care or parking or legal services or health, or whatever. And just that element becomes very important to me.

If I have questions of the witnesses, they will deal with what they feel about putting some kind of cap on the overall benefits.

But, Bob, I really think this is terribly important. It is a very difficult area. There are many, many ways to approach this and many opinions on how to do it, and I compliment you—who has a definite philosophy on this subject—for taking on this subject, and I thank you for giving me an opportunity to be a part of it.

Senator PACKWOOD. Dave, this is an easy one to be on my side on. You weren't here when I said earlier, we had 110 requests for testimony. There was Buck Chapoton and 109 against him. This is a no-lose situation. [Laughter.]

I want to ask Ms. Koralik a couple of questions, although the rest of you can comment if you want.

On page 5 of your statement Mrs. Koralik, you say that growth will come in three areas, the third one of which is the addition of some new benefits such as dependent care.

I thought your statement was very good about why health benefits have grown and how it was narrowed down. The debate you run into, apart from those who will cite some very specific grievance of a small corporation composed of six lawyers who have contorted the Tax Code to take advantage of benefits—those we can pass laws to prevent. The bulk of these benefits go to the broad middle-income worker, and we all know that.

Those people who want to use those examples to get rid of these employee benefits will never be satisfied. They want to get rid of the benefits, and they use those outlandish examples to prove it.

As far as excessive costs are concerned, employers are getting pretty good about negotiating. They know the costs. Yesterday we had some testimony from a variety of witnesses involved in the provision of health care. As new contracts are negotiated, the coinsurance or the deductibles are raised to try to hold the cost down on health care. I'm not worried about those becoming outlandish. But the interesting change you have is the change in philosophy of society as to what should be collectively provided.

If we were talking 50 years ago, no one thought it was society's obligation to provide health care. We might have had county hospitals for the very poor, but that was all. For the rest of the people, you provided your own health care. The Government didn't provide it, and business didn't provide it. That philosophy is now totally changed, and we think it should be provided.

So the question comes: Is it best provided by Government, or by employers? I think it clearly is best provided by employers. If employers provided retirement medical insurance, I don't think we ever would have started down the road on medicare, by and large. It was started because there was a huge void that was left when people retired.

But the question and the fear in some people's minds is what is a legitimate benefit to be collectively provided, whether it by Government or industry?

As you are well aware, some of your companies have done studies on the Japanese system of employee benefits, which is extremely broader and more in depth than ours. Japan provides almost all benefits through business that other governments often provide through Government. The United States is kind of midway between most of Western Europe and Japan in terms of employee benefits.

Every now and then when we discuss this subject, opponents will say, "Well, it's going to lead to—," and then they will cite automobile repair as an example of what is going to be provided next as a tax-free fringe benefit.

We now have prepaid legal as a fringe benefit, we had education, we have day care, we even have van pooling if employers want to provide it. It turns out that from an energy standpoint it is still the most efficient way to transport people. Those vans haul eight or nine people, and if the seats come out, the employer can make some delivery use of the van between 9 and 3 and then put the seats back in and take the employees back home again. It's an ideal way to save on gasoline.

Do you think that group home and auto insurance is a legitimate fringe benefit that should have tax advantages?

Ms. KORALIK. From the tax standpoint, it's an item of security covering liabilities that could not be anticipated—the loss of a home, for instance.

Senator PACKWOOD. Well, that isn't quite right; those are liabilities that can be anticipated.

Ms. KORALIK. Well, you don't expect your house to burn down, and you don't have money set aside to build a new one if it does burn down.

Senator PACKWOOD. No, but my hunch would be that most homeowners have fire insurance.

Ms. KORALIK. All right. So you are going beyond——

Senator PACKWOOD. I am assuming that most anticipate the possibility of the house burning down.

Ms. KORALIK. So you are not talking about fire insurance. You are going beyond that to theft in the house?

Senator PACKWOOD. Yes.

Ms. KORALIK. Even that. You wouldn't anticipate being burglarized.

Senator PACKWOOD. No, I don't think most people would think they are going to be burglarized, unless they live in New York City.

Ms. KORALIK. I have lived there for 10 years, and I haven't been burglarized, so it's not too bad.

Senator PACKWOOD. All right.

Ms. KORALIK. So, to the extent that it is something that people can't anticipate, they do need insurance for it. But I guess I'm not sure that it is something we need to subsidize through tax-favored treatment.

Senator PACKWOOD. Is van pooling something that should be subsidized? That arose in during the energy crisis days. The energy crisis will come again—as sure as we are sitting here. That was undertaken to encourage people to use the vans and get out of their cars, and to the extent it is provided by employers it works; but should we use the Tax Code to do it?

Ms. KORALIK. I think that has a slightly different flavor in that there is another social good that is being served, in terms of conserving energy. So perhaps there is a legitimate case for that. I would agree with that.

Senator PACKWOOD. Let's move on to home ownership. We clearly think that is a socially good value. We allow the mortgage interest deduction because we think if people own homes they will be better citizens; if they have to mow the lawn and paint the roof and fix the fence. I question the conclusion from that when I am painting the roof and fixing the fence. [Laughter.]

But that is neither here nor there. Having reached that conclusion, why then shouldn't we encourage employers to provide home ownership in some form? Whether it be employer loans on a tax-free basis with no imputed income and tax? Why isn't that a worthwhile social objective?

Ms. KORALIK. Well, there I think the social objective is being met through the direct tax deduction on the personal income taxes for mortgages With health insurance and other benefits, you either have the employee-sponsored plan or you have the tax deduction.

Senator PACKWOOD. Home ownership is a good goal. It has been going down recently, however, especially among younger people who simply cannot afford it.

Ms. KORALIK. That's true.

Senator PACKWOOD. In the era I grew up in, you got out of school and by the time you were 25 and married you could buy a house for $8,000 or $9,000, if you had $2,000 down. Those days are gone.

Ms. KORALIK. They are gone.

Senator PACKWOOD. Now, if we wanted to encourage that, especially among younger people in order to make them feel stable, what's wrong with the business of having some tax incentive to provide home ownership in one form or another? Again, it could be a down payment; it could be help on your payment; there are a variety of ways you could structure it.

Ms. KORALIK. I hadn't thought about it. It seems——

Senator PACKWOOD. I throw these out only for those who want to put limits on these types of benefits. They say, "Well, in that case there is no limit to what an employer can provide if the employer and the employee or the employees' bargaining representative have concluded that this is good for the employer-employee relationship and helps productivity. The Government should not interfere in the decision between the employer and the employees. There should be a tax incentive for anything that the bargaining agent and the employer agree to." If you say No, then the Government says, "Yes, we think items 1, 2, 3, 4, 5, 6, 7, 8 are good things; but items 9, 10, and 11 are not, but society may change and maybe in 10 years they will be good." You've got to do one or the other;

either the Government has to say we'll encourage certain things, or we have to say we have reasonable faith in the free enterprise collective bargaining system and whatever is jointly agree upon we'll go along with as a tax incentive. The employers will not willy-nilly fund all kinds of benefits because they are paying the expenses of them.

Ms. KORALIK. I would agree With that.

Carson, do you have a comment?

Senator PACKWOOD. Mr. Beadle.

Mr. BEADLE. Senator Packwood, I think you are right on the money on that point. The issue really is, what are those social objectives that the Government would like to see encouraged in the country? And then, what is the best method of achieving them?

I think sometimes we have come at them a bit backward; we have worked on traditional practice, and all the rest. If the mood of the Nation is that people should not be especially encouraged to have homeowners insurance, then there is no point in having an incentive. Whether tax is the only incentive is something else we haven't really examined in depth.

We have seen that tax preferences can create an environment conducive to the private sector showing a little more interest in the subject, and that little more interest is converted into some mighty potent achievements.

But at times I don't feel we have thought through carefully enough what it is we really do want to achieve and whether tax preferences and what form of tax preferences is most likely to help achieve it.

I say again that I applaud so much what you are doing; I think you are back to the fundamentals that should guide us into the right answers.

Senator PACKWOOD. An interesting, relatively new one is prepaid legal plans. The Government has gotten into it with the Legal Services Corporation. There are people in this country who cannot afford their own legal services. When you look at the costs of lawyers today the average Jane or Joe cannot afford lawyers. Maybe they can afford an uncontested divorce that you see advertised on television, or a will, if that's indeed all it is, for $175 or $200. But when it is a genuine landlord-tenant eviction case where you might be talking about $500 or $1,000, or quite a bit more for a contested case, they can't afford it.

So we set up the Legal Services Corporation. Initially it was going to fund services just for the poor. This administration is adverse to it, and it hasn't grown much; but given an administration that wanted it, I could see it grow immensely. The alternative for many people could be employer-provided legal insurance. Put a deductible on it; and make the employee pay the first $300 or so of the lawyer's fee. For the case where you are going to get hit with a $2,000 to $5,000 lawyer's fee, that is not something the average person expects or saves for. When it hits them they simply haven't got the money, and they probably go badly represented or not represented at all, or they give in on a right that should be defended because they can't afford to defend it.

Mr. BEADLE. Whatever system we use there are going to be situations where some will argue that that is going to increase the use of legal services, some are going to say we are going to leave people vulnerable to expenses. But I think in that instance, for example, the definition can be one that confines the benefit to personal legal costs. You can do it through definitions.

Senator PACKWOOD. That last issue about how litigious this nation is is another issue.

Mr. BEADLE. Right.

Senator PACKWOOD. Again, I look at Japan and the relatively slight amount of lawyers they have in relation to their population and the number we have, and the quantity of different courts we have in this country and their calendars. I think that is a problem far separate from whether or not we are going to have tax incentives for it. I think the problem of court clogging and litigiousness is going to go on regardless. Whether we come to arbitration, or whether we come to no-fault insurance is another issue entirely.

David.

Senator DURENBERGER. Thank you.

There is a temptation to follow up on Bob's logic in my line of questions, but I think what his questions have illustrated is that first we have to define and make some judgment about the larger public good that is being met by the intervention of Government via the Tax Code in the normal decisionmaking processes that people would make.

Second, it strikes me that we have to look at alternative ways for meeting this need, to utilizing the employer-employee relationship and the incentives of the Tax Code. The question relative to home ownership illustrates that.

There are other ways to go about health care, for example, than the way we presently provide the deductions and the exemptions in the Tax Code. We could simply provide for a larger deduction off of the individual income tax of some kind for out-of-pocket expenses to meet particular health care needs; we could put a particular deductibility on premiums, and we could put some other kind of feature on something else.

And certainly before we get into a wholesale selling of legal insurance in this country, when we know ahead of time that we are too litigious and have too many lawyers and all that sort of thing, it strikes me that before we go whole-hog into that business—and I understand the inequities and so forth, but to go whole hog into that then it just creates a whole new impediment to ever changing a litigious society.

So I think what Bob is suggesting to us all is really very important, that we on the Government side look at the alternative ways of "using" the Tax Code, if you will, to approach some of these subjects.

Now, I wonder if—I don't know all of your backgrounds and so forth, but I would appreciate some feedback from you all on flexible benefit plans, cafeteria plans.

If I read this thing yesterday correctly, Buck in effect doesn't like them—I can tell that—and I thought some of his arguments a little specious. One of them—and this one might not be; I don't know—is:

Employee disagreement over desirability of particular non-taxable benefits has served historically as an important restraint on the amount of compensation provided in any one form.

In other words, he is saying if you make them fight among themselves over whether or not we are going to have insurance this year or whether or not we are going to have pension this year or something else, then that is sort of a natural restraint on the growth of benefits.

Once you come along with your cafeteria, and you set your current plans in your cafeteria, and you start easing up this conflict, if you will, because you have individual choice, then Buck claims you are going to run the cost of these programs through the ceiling.

I would appreciate some reaction on that subject.

Ms. KORALIK. First of all, I think we all do like flexible compensation on this panel; but more specifically on that issue, I think employers are another constraint on how much is going to go into employee benefits. They don't want to just keep on pumping up the number of dollars going into these programs. In fact, most of the employers who are looking at flexible compensation programs today are looking at it not so much as a way to do something nice for their employees but as a way to get some control over the benefit costs.

One of the things that we are hearing quite a bit recently is that we have got to change medical programs from defined benefit programs where you just have a blank check saying, "No matter what happens, when you go into the hospital it will be paid in full, and we will always pay the premium." They are trying to change over to what they are now terming "a defined-contribution approach," to say:

We will pay this much for your medical insurance premiums, and we will give you a choice of three programs—there is one that is less expensive than our allowance, one that is equal to the allowance, and one that is more expensive. If you will step down, we will give you something else with the remaining dollars. If you want to go up to the most expensive coverage you've got to pay the difference. But in the future we are not writing out this blank check that says no matter what happens to that expensive coverage we'll keep picking up the tab.

So I don't think he is correct in saying that employers are just letting it run wild; they are trying to stop it.

Senator DURENBERGER. You are ringing my chimes when you talk about what choice actually leads to, because you are telling me that the bureaucrats and IRS and Treasury think all employers are captives of the employee organizations in this country. And I think there was a day when that was true, but my sense is that isn't the way it is today, and that cost restraint as well as being sensitive to the fact that the young are not quite the same as the old, and families are not the same as single people, and so forth, this is what comes with cost constraints if you will, or limited—so-called limited—resources in this country.

But as you described the choice of health plans, I just use that as an illustration.

One of the concerns here, then, would be that, yes, some companies might do that. It is very logical to have an equal contribution to each of these plans. But unless Government says that the tax benefit is to be qualified by an equal contribution to the requirement of at least three plans and then the ability of the part of the employee to choose less and to get a taxable rebate or another benefit, or whatever the case may be—all of those things I love—but unless we mandate that, it isn't going to happen.

Ms. KORALIK. I disagree with that.

Mr. ALLEN. I do, too.

Ms. KORALIK. The trend has been tremendous toward increasing the number of flexible programs. It is something that historically has not been easy. There have been a number of questions about how do you administer these programs and can you underwrite these programs where you have multiple choices if you have a fairly small group of employees. But I think now we have reached a point where we have enough experience, where there are computer systems available for employers to manage these programs, that the number of these programs is just escalating very rapidly. I would disagree with that.

Senator DURENBERGER. One key element, too, is that they are really hired on this taking cash back, even if it is a taxable and flexible fringe benefit plan. But that is some key element to let people take less of this if they just don't need it and to have a cash option, is it not?

Mr. ALDEN. We find this utterly baffling, that the giving up of a benefit that was wholly tax exempt, deductible by the corporation, and tax free to the recipient, that giving up part of that and exchanging it for taxable cash is going to reduce Treasury revenues.

Mr. ALLEN. It is very hard to understand.

Mr. ALDEN. It is absolutely backward.

Senator PACKWOOD. As a matter of fact, at the end of the Tax Conference I posed that issue to Buck Chapoton, because they were opposed to it I said, "Buck, if you aren't going to allow it to be rolled forward next year, then you have no taxable income. If they are allowed to cash out, they pay a tax on it, you have to pick up revenue, because you are deferring it otherwise" And he said, "Yes, you do." They still didn't like the whole idea, but you had to pick up revenue. You were starting from no revenue, so whatever you picked up was more than you were getting.

Mr. BEADLE. Regardless of how we arrived at it, the flexible approach that has been introduced into the American system has been very, very timely. What we are really talking about is a system that allows for the best use of the available dollars for the income security needs of a rapidly changing work force, people with very different needs. The old group approach was to treat everybody the same, and that had waste in it. We are just removing the waste.

Senator DURENBERGER. I have one last very brief question. This is the equity question that we are going to have to deal with, and it also has some other benefits that I won't go intc. Would you react to the value of a cap, putting a dollar cap of some kind on the tax benefits, if you will?

Mr. BEADLE. I would like to make a brief comment, then I think my associate here has been giving some special thought to that.

The flexible approach is a new approach. It has had some weaknesses in it, has had some very fundamental strengths in it. I think if our time had been spent rather than on defending the whole process how we might refine it so that it will achieve the public policy that is the objective, then we would have some idea of what form of cap. I think a cap of some kind is quite acceptable; our survey indicates that it would be acceptable. The form of it is going to be terribly important to get right, or we are going to have another unintended result of the action.

Mr. ALLEN. In our written testimony we do comment on this. We point out that if caps are considered, it is critical to observe the nature of the benefit that you are capping, and that plans that are benefit oriented should probably be developed with a benefits-oriented cap rather than a dollar cap. For contribution plans such as 401(k) plans, savings plans—it is more appropriate to choose a dollar some other pay-type contribution limit.

For example, we think medical would be much more effective if we used a cap that is oriented toward the benefits provided, not to the costs of the program.

Senator DURENBERGER. Thank you very much.

Senator PACKWOOD. Thank you very much.

Next we will have Frank Mason, president of the Mason Corp., speaking on behalf of the Chamber of Commerce of the United States. I see he is accompanied by Don Alexander, a former commissioner of the Internal Revenue Service who is well known to this committee, and who has ably appeared here in many capacities.

It is good to have you here.

STATEMENT OF FRANK L. MASON, PRESIDENT, THE MASON CORP., BIRMINGHAM, AL, ACCOMPANIED BY DONALD ALEXANDER, ESQ., MORGAN, LEWIS & BOCKIUS, WASHINGTON, DC, ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, WASHINGTON, DC

Mr. MASON. Good morning, Senator.

Senator PACKWOOD. Good morning.

Mr. MASON. As you mentioned, my name is Frank Mason, president, Mason Corp., a small business located in Birmingham, AL, and with me is Mr. Alexander, as you pointed out, with the firm of Morgan, Lewis, and Bockius. We are here to appear on behalf of the U.S. Chamber of Commerce and its 200,000 business members.

My interest in employee benefits stems really from my own experience with my company, its profit-sharing plan, and its employee benefit program. Our company began profit sharing in 1954. We had only 25 to 30 employees and one location in Birmingham, AL. Today we have 180 employees and a location in Birmingham, Dallas, Raleigh, NC., and a warehouse in Kansas City.

So I know from firsthand experience what the profit sharing and the employee benefit program can mean to the growth of a small company and the relationship between the management of that company and its employees.

This hearing offers, I think, a very unique opportunity to express one thought that I have, and that is, if it ain't broke, don't fix it. If it's working, and we believe it is, then don't tinker with it. If we must tinker, our recommendation would be to improve the circumstances under which small business can afford to have employee benefit programs within the company.

As was mentioned a little earlier, the changes that have occurred in the Tax Code from ERISA, ERTA, TEFRA, and this most recent effort, have simply complicated the process of providing these benefits to the employees.

In our written testimony we talk about the reasons for having the benefits, but in our case I can say that our company has grown because we have had profit sharing. It means a great deal to the employees in their planning for their future. Each time these changes come along, our company and tens of thousands of other small businesses are confronted with several thousand dollars of expense to get the plans changed and to be able to continue. Even with ERISA our attorney advised us, in our case, "I think you ought to drop your pension plan, because it is just going to get more complicated, and curtail the benefit". So far we have maintained it, in spite of that advice, because we feel that the relationship that we have with the employee as a result of providing these has allowed us to retain better quality employees and in turn do a better job.

I was interested in your comment as to why more CEO's are not here. I can say that I'm not only a CEO, but the fellow that signs the note on the back at the bank when we borrow the money, and sometimes floor sweeper. [Laughter.]

So I really do appreciate the comment, and I think it is very important that more CEO's do appear. I think from the small business standpoint those of us in small business are so busy trying to meet Friday's payroll that we really don't have the time and the resources to do all of the homework and to appear in many cases where we should be.

One thing that was mentioned—maybe I will get a chance to chatter about that in a moment; I see that my time is running out.

I would just like to ask Don if he has any comments to make before we are off on the time here.

Mr. ALEXANDER. No, I think you have done it very well. We might try to respond to some of those questions you put earlier.

Senator PACKWOOD. I am delighted to have the chamber of commerce on record in favor of this.

I will come back again to this interest of CEO's in this. The mail is no longer necessarily an accurate barometer of what people think. Almost all of it is instigated, and you can't necessarily count on it being an accurate reflection of your State.

We can go home and spend a couple of weeks there, and by the time you have spoken to a dozen service clubs and met with the county commissioners and city hall and spoken at high schools in one-high-school towns where the students are marvelous reflections of their parents, and you have met with the labor union, you have a reasonable idea of what is on their minds. The issue of the taxation of employee benefits never comes up. Now, I shouldn't say that. With the unions it comes up; I don't know if it is their No. 1 priority but it's a very, high priority for them in this Congress.

But big and small, it is not raised by either the major owners or CEO's of corporations, and I don't know why.

Mr. MASON. Could I respond to that, as I see it? I think one of the problems may be that a good many of the small business people and their employees are not really aware of the extent to which the scrutiny is being placed on this area by those who would tax it. I think that as this becomes more apparent to the employees and to those small business owners, there will be a much greater response to that situation.

Unfortunately—and I use the illustration of OSHA—most small business people were not aware that the OSHA law had been passed until the inspector came in and fined them. And I think that is really the case, that they are not really aware of what is about to happen.

Senator PACKWOOD. The example I have used more often is Pepsico. Pepsico shifted to a flexible benefit plan and gave the employees an option on madical insurance. Many of the employees chose a much lower option. The upshot of it was that the Federal Government collected about $1.2 million in additional revenues because they shifted into other things that were taxable. It worked out that it cut Pepsico's medical costs and increased the revenue to the government. They use this as an example of what will happen if we have this flexibility.

Their lobbyist Max Friedersdorf was excellent; he was calling my office daily. I didn't ask him, but I'll wager that Don Kendall never called Donald Regan about this subject. This whole thing could be put to rest if the President and Donald Regan would say, "We're done with this nonsense. We don't want any more of these taxation ploys and flim-flams or employee benefits." But I'll bet you that kind of a call was never made, because, for whatever reason, it didn't rise to the dignity of selling Pepsi Cola in Vladivistok or something like that in Don Kendall's mind.

Mr. MASON. Hopefully we might be able to be helpful in that.

Senator PACKWOOD. All right.

David.

Senator DURENBERGER. I guess I just need to clarify "if it ain't broke, don't fix it." You use the example that people don't know that OSHA is here until the inspector walks in the door. Well, let me tell you, when the folks find out that the FAST tax, the FLAT tax, the whatever it is here is here, they are going to say, "Hey, I wish we would have fixed this thing, because 'it was broke.' "

We somehow tend to ignore the fact that everyone of these decisions that you take for your employees on health insurance, life insurance, everything else, is just like sitting up here in an appropriations committee spending taxable dollars. Collectively, as employers in the health care area, by 1988 we will be spending $35,975 million of taxpayers' money per year, in effect, in revenue foregone because of these benefits.

Now, I am sounding like a liberal because I'm talking like it's my money, you know—that sort of thing. I go down the line in—let me pick a really big one—the net exclusion of pension contributions and earnings for employer plans with $49,700 million in tax expenditures, revenue foregone or however you want to characterize it, in 1983, rising to $109 billion in 1988. Here is the individual retirement plan. There are a lot of those kinds of things.

When the flat tax hits us, or whatever it is that is going to hit us—I mean, the OSHA inspector walking in the back door is nothing compared to what happens if we get assaulted by the elimination of some of these spending things.

So I guess what I am trying to figure out here is what we mean in the Chamber by "if it ain't broke, don't fix it." I mean, we've got a system, coming back to the health insurance where Chrysler, a company which was going broke 3 years ago, paying out $6,000—they aren't paying it out; the Government is paying it out for them. You and I are subsidizing for these people $6,000 per employee and retiree every year for a health plan.

Now, I'll bet I could go to the U.S. Chamber and find a lot of your members that aren't getting anywhere year a $6,000 a year exemption; they are paying a heck of a lot more for a lot less health insurance because we are sucking so much into the Chrysler side of this system. You've got a lot of good chamber members out there who have the high deductibles and copayments, and you are doing all the right things. But Chrysler isn't, you know? Their president says we ought to have a national health insurance program, We ought to regulate this health care system. And we are forking out on his behalf $6,000 per employee per year.

I wonder if there isn't something in here that is just a little bit "broke," that maybe we ought to fix.

I know that is really not a fair question of you, Mr. Mason, but I am trying to get at Don and Dave and everybody else, too.

Mr. MASON. All right. I might respond, if I might, just briefly on that. In our case, in our company, we noticed that the health care costs have risen to, at one time, $40,000 to $50,000 a year and began to get to the $200,000 to $250,000, and with a little projection we could see $300,000 to $500,000 a year if the trend continues.

We did switch to what I find now is a VEBA. We have a trust that we put money into, and it pays. But we explained to our employees this: "If you have a discretionary choice in your health care that you buy, then let me urge you to do what my wife did, and that is she had knee surgery but on an outpatient basis. There was no overnight stay in the hospital and she was able to get by with lest cost for that treatment by doing that." As a result of a meeting with employees in groups of 10 or 12 at a time, we went through and explained that we could either spend it over here in the health care, or we could spend it over here in the profitsharing. "Now, you make the choice in your case as to how you want us to spend that money." And the result has been that we have been able to contain the costs of our health care service. I don't know whether the employees are just naturally more healthy or whether somewhere they have made some decisions that have contributed to limiting the growth of that cost as it applied to our company.

So I think that there are cost restraints. Even though it is a tax deductible item for the corporation, it doesn't mean that the corporation can discount completely the cost of whatever the benefit is. So I think there are constraints on how much benefit a company, especially small companies, and those are the ones I am most familiar with, there is a limit to how much they can put into a total employee benefit package. And while we don't have the flexible benefits offered by some of the larger corporations, that may be a better way of controlling the total amount of cost to the corporation, if employee has the option of choosing. In other words, "this is how many dollars we have, and you decide which of these is going to be to your best interests."

Senator DURENBERGER. I am sure glad I let you answer that question, because you are more credible than these guys are—with all due respect. [Laughter.]

And I think you have just talked about a part of the system that we shouldn't be tinkering around with. I mean, all this stuff that Bob and I believe in in this system does work well, because it facilitates your decision. All I want is to somewhere get in the record here—and you don't have to belabor it today—is that there are other folks that aren't doing that. And all the folks who were here yesterday, or a lot of the folks who were here yesterday with the AFL-CIO or something behind their name, I wasn't here but I know darned well what they said. You know, "Don't touch it. There is nothing wrong with first-dollar coverage; there is nothing wrong with $6,000 per employee." Yes; there is something wrong with it, because it is raising your costs.

Now, you can fight off those costs by making your employees pay a little bit more and "go get a second opinion," and go do all this sort of thing, but they ain't doing that much at Chrysler because they are captured. Now, they are going to break loose from that, slowly, but it seems to me there might be one or two things we could figure out to do within this fringe benefit area that would encourage the Chryslers of this world to move just a little bit faster and lower the burden on the rest of you.

Mr. ALEXANDER. Well, now that my lack of credibility has been established. [Laughter.]

Senator DURENBERGER. It's just like comparisons, Don, that's all. [Laughter.]

Mr. ALEXANDER. And quite properly. Mr. Mason speaks for the Mason Corp., and in the Mason Corp. it is working, and it is working darned well. And the concerns that are reflected in those numbers don't exist.

Now, are those numbers real? I wonder about the revenue estimates of the tax expenditure for retirement plans and all the great benefits that go with those plans. I think it materially changed; it went up in the last year or so from the number computed by a somewhat different mechanism before. And I guess because of being with the Internal Revenue for a while I'm very skeptical about numbers, the Internal Revenue's or anyone else's. I am somewhat skeptical about these.

None of us, I suppose, can speak for Chrysler—they can speak for themselves. In the Mason Corp., by gosh, the planned use of the tax system here to assist in meeting a national need through the private sector is working. In the Chrysler Corp., perhaps it's not working. But a cap might not work very well either, for the very reason that you suggested earlier, Senator Durenberger. You pointed out that this was a very disparate field, that people's needs differ, that there are geographic differences, and differences, of course, in age.

I don't need any child care, Senator Packwood; although that, of course, is a comfort to my wife. [Laughter.]

So a cap would have to be very carefully crafted. A percentage cap might make more sense than a dollar cap.

Senator DURENBERGER. I should say the bottom line is, what is the chamber's position? So often, with all due respect, the chamber comes in and says, "If it ain't broke, don't fix it," and 6 months later we pass the piece of legislation without the chamber being involved in it, and we have probably goofed it up.

So do you have a position that conforms to something I heard from the other panel, which is, "Yes, we are willing to look at it, and it needs to be examined because of the disparate nature"? You haven't rejected the possible notion of a cap, have you?

Mr. ALEXANDER. A witness testified in 1983 for the chamber raising serious concerns about the operation of the cap. I do not believe the chamber's position has changed since then.

Of course, the chamber is prepared to work with this committee and other committees of Congress in trying to arrive at a sound balance between satisfying a public need and producing the revenues that this country needs to operate on.

Senator DURENBERGER. Thank you.

[Mr. Alexander's written statement follows:]

STATEMENT
on
EMPLOYEE BENEFIT TAXATION
before the
SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT
of the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Frank L. Mason & Donald C. Alexander
July 27, 1984

Good Morning, I am Frank L. Mason, President of Mason Corporation of Birmingham, Alabama. With me is Donald C. Alexander of the law firm of Morgan, Lewis, & Bockius. We appear today on behalf of the U.S. Chamber of Commerce and its 200,000 business members.

Both Mr. Alexander and I serve on the Chamber's Board of Directors. We are members of the Chamber's Employee Benefits Committee which I have the privilege of chairing. Mr. Alexander also serves as a member of the Chamber's Taxation Committee. Mr. Peter Kelley of the law firm of Kirkland and Ellis contributed to this statement.

As Commissioner of the Internal Revenue Service (IRS) from 1973 through 1977, Mr. Alexander is well known to members of the Subcommittee. As tax partner in his firm, his practice often entails representation of clients with problems involving the tax treatment of employee benefits.

My interest in employee benefits is drawn from my experience with my company, its profit-sharing plan and other employee benefit programs. The Mason Corporation began its profit-sharing plan in 1954, when we had only a handful of employees operating out of just one location in Birmingham, Alabama. Today, we have 180 employees in three plants located in Alabama, North Carolina and Texas, with a warehouse in Kansas City. As a founder of the company, I know what this profit-sharing plan has meant to our growth, to our employees and to the development of our special relationship with our employees.

We welcome the opportunity to express the Chamber's support for a strong, voluntary, private sector employee benefit system.

These hearings offer a unique opportunity to evaluate the origins and benefits of our present tax policy as it relates to employee benefits. In brief, our recommendation to you is that "if it ain't broke, don't fix it." If it's working -- and we believe it is -- don't tinker; but if you must tinker, then simplify the rules and strengthen the incentive for employers to take on the obligation of sponsoring employee benefit plans.

<u>What Employee Benefit Programs Have Accomplished</u>

In order to provide a framework for an evaluation of taxable and tax-favored employee benefits, Congress must focus on some of the important benefits that result from the current system.

1. <u>Substantial risk protection for more than 30 years</u>. Private employee benefit programs have provided substantial risk protection to American workers and their families for more than 30 years. These programs are broadly-based in terms of numbers of participants and beneficiaries affected. They provide pension and medical coverage to primarily middle-income Americans.

Employee benefit programs provide coverage to approximately 150 million participants and beneficiaries and are maintained by over one million employers according to the Employee Benefits Research Institute.

More than 74 percent of all workers and nearly 89 percent of full-time, full-year workers participated in an employer group health plan in 1979.

2. <u>Maintenance of a less extensive and less costly Social Security system and avoidance of the burdens and chaos of a broadly-based national health system.</u> At the same time that private employee benefit programs have assisted in the growth of the most advanced health care delivery system in the world, they have permitted our government to avoid much of the burden and chaos that other developed nations have experienced in implementing national health care systems. The costs and burdens our nation would have been forced to undergo over the past 30 years, if the private retirement system were not in place, is simply incalculable. However, it is safe to say that advocates of the present tax incentives were correct in the early 1940's when they argued that the alternatives to those incentives would be much more extensive government expenditures for social programs.

3. Government and private sector cooperation. Experience has shown that governmental programs for the delivery of services often produce a uniform system of benefits delivered with heavy administrative costs. Such a system is frequently inefficient, laden with questionable procedures and inadequate delivery systems, that serve to frustrate employers, employees and beneficiaries.

In the current system, employers have voluntarily established a highly diverse private system, with minimal federal guidelines, that serves the unique needs of our diverse workforce. The result is a flexible system that meets the needs of our workforce.

4. Encouragement of a sense of affiliation with the employer leading to increased employee productivity. Employee benefit plans, provided on a voluntary basis by employers, create an important bond between employers and employees. Employer sponsorship gives employees a greater sense of their role in the success of the enterprise and provides them with a greater stake in the outcome of the economic activities of their employer.

5. Important source of savings and investment. Institutional investors have become the single most important source of capital to the financial markets. Retirement funds have become the largest single component of this institutional investment. In this regard, it is noteworthy that the objective of building pools of investment capital was one of the underlying motives for the adoption of some of the tax incentives offered with respect to private retirement programs.

6. Hedge against inflation. In the early 1940's, one of the justifications for tax-deferred employee benefits was to dampen aggregate demand, in order to combat ruinous inflation that could have weakened our wartime economy. Any study of the benefits of retirement plans should examine the impact deferred retirement plans may have in fighting inflation.

It should be remembered that the 1938-39 survey of profit-sharing, undertaken by this Subcommittee under the direction of Senator Vandenberg, led to tax legislation that encouraged the formation of employee benefit programs.

The Growth and Composition of Employee Benefits

Since 1951, the Chamber has conducted the most comprehensive survey on the level and growth of employee benefits in the country. Employee benefits have grown from 18.7% of payroll in 1951 to 36.7% of payroll in 1982. To put this in perspective, wages and salaries grew 815%, and inflation increased 271% over the same period.

As Table 1 on page 8 shows, the growth of benefits has not been uniform for all types of employee benefits. For example, employer discounts have increased 43% from 1971 to 1982, while unemployment compensation taxes rose 350%. Table 2, on page 8, demonstrates the wide discrepancy in employee benefit costs between industry groups, ranging from $69 per employee per week for textile products and apparel to almost $237 per employee per week for the petroleum industry. While the growth in tax-favored benefits has grown faster than taxable benefits, the latter comprises a commanding share of the total employee benefit package.

The most obvious conclusion from the data is that taxable employee benefits are the largest component of the total employee benefit package. The data in Table 3 on page 9 indicate that 73% of all employee benefits are fully taxable. These include FICA taxes, paid vacations and profit-sharing payments. Twenty-four percent of employee benefits is statutorily non-taxable and includes insurance and workers compensation. A substantial part of the taxable benefits are legally required employer payments, such as social security and unemployment compensation. Other benefits, such as pay for time not worked, rest periods and paid vacations, are discretionary but depend to a large degree on industry practices.

It is predicted that the growth in employee benefits and the widespread use by employees at all income levels should continue, albeit at a slower rate. The major threat to such growth is the possibility of further tinkering with tax-favored employee benefit programs. This causes uncertainty in the business community, making adequate personnel and corporate planning difficult. Businessmen like certainty; without it, many small and medium-sized firms likely will drop various employee benefit programs. Ironically, these tend to have lower paid employees. The result will be a decline in the benefits available to all employees.

"Tax Expenditure" Estimates

Critics of our present system of tax-favored employee benefits point to the estimated growth in so-called "tax expenditures" over the last several years, as reported by the Congressional Budget Office.

The "tax expenditure concept" is meant to identify and quantify deviations from the ideal tax. Thus, any abatement relative to what the tax liability would be, given both the tax rate and the ideal tax base, is quantified and labeled a so-called tax expenditure. A recurring problem with tax expenditure analysis is, simply, the utter lack of widespread agreement about what constitutes the ideal tax base.

There are, for example, differing conceptions of what constitutes income. Should capital expenses be treated as expenses or singled out for less favorable treatment? Should savings be treated as income taxable when accrued or simply left out of the calculation of income altogether? Does a taxpayer have any income if a catastrophic, life-threatening illness forces him to spend as much as he earns in a given year on medical expenses? Should the ideal tax base, against which "tax expenditures" are measured, include or exclude income "exempted" for "fairness" reasons? These and many other similar questions are the sort which give rise to the lively controversy surrounding the ambiguous term "tax expenditure." "Tax expenditure" estimates are unreliable at best and should not be used as the sole criterion in evaluating the efficacy of tax-favored employee benefits.

The tax code is situated uniquely to achieve public policy goals unrelated to the ubiquitous aim of raising needed revenue. It is desirable that the vast majority of the American public be covered by health and life insurance and have adequate retirement savings. The tax code has succeeded in encouraging the private sector to provide these goods efficiently to the American public. This goal should be incorporated into the concept of the "ideal" tax base for purposes of "tax expenditure" analysis.

Tax Policy and Tax-Favored Employee Benefits

Excluding the value of employee benefits from taxation, or deferring any tax that is imposed, induces employers to provide more compensation in the tax-favored manner. Business firms tend to adjust their behavior, providing more tax-favored benefits and less taxable cash remuneration. In turn, labor markets adjust until the tax savings of providing a given amount of non-cash compensation equals the marginal value of that form of compensation to employees. After all, one can use only so much health insurance or clothing even if bought at an employee discount. There is a limit to how much money a taxpayer can afford to put away for retirement.

Tax-favored benefits make employers more secure financially; they reduce the risks which an employee faces. They protect employees and their families from the adverse financial consequences of catastrophic illness, death or a poverty stricken retirement. Health insurance, life insurance and retirement savings are part of any sound, long-term financial plan.

Present tax policy also encourages sound retirement planning. Thus, for example, over 80% of the population is covered by private health insurance and will not become a burden on either private charity or government entitlement programs (such as Social Security or Medicare) because of a sick or penniless old age.

In the absence of the tax incentive, many people would find it difficult to provide for retirement or have adequate medical coverage. The burden on private charity and government would therefore be increased.

The present private sector system works. Although the salaries of those earning under $25,000 annually constitute only 39% of total compensation paid each year, those earning under $25,000 currently constitute 76% of those covered by pension plans and enjoy 70% of all vested benefits. Less than 3% of those covered earn over $50,000. These figures further rebut the assertion that pension plans are tax shelters for the wealthy.

Some benefits, such as medical and education expenses, should not be viewed as economic compensation at all. Instead, they should be viewed as investments in human capital, as expenses incurred to facilitate earning more taxable income in the future.

Lastly, the private savings generated by private, tax-preferred pension funds have been a necessary component of capital formation. Government plans, such as social security, have a record of poor financial management and, therefore, do not accumulate capital out of which to pay benefits.

The Need to Renew Section 127 and Revise Section 125 Cafeteria Plans.

Employer provided educational assistance, Section 127, should be extended permanently. The decision of the Tax Conference Committee in June not to extend that section is a disincentive to the nation's workers, extend that section is a disincentive to the nation's workers, particularly those at lower wage levels. They will find it more difficult to acquire the new knowledge and skills needed to cope with a changing workplace. The decision has caused great confusion among employers who have not withheld taxes and may be subject to interest charges and penalties.

Lastly, the restrictions placed on Section 125 cafeteria plans by the recently enacted Deficit Reduction Act of 1984 are counterproductive, and should be revised.

Conclusion

As our review of the favorable impact of employee benefit programs indicates, the federal government's involvement in encouraging employee benefit programs has been a resounding success.

Private sector employee benefit programs are broad-based and have achieved the national policy mission set by Congress, and will continue to achieve those objectives even in the face of demographic trends indicating a tremendous growth in dependency of our citizens. After reexamining the benefits of this system in these hearings and in hearings and studies yet to be conducted, this Congress and future ones should express its resounding reaffirmation of the national policies which have produced the strong, voluntary, private sector employee benefits system.

TABLE 1

Weekly Employe Benefits, per Employe

	1971	1982	Percentage Increase
Old age, survivors, disability and health insurance (FICA taxes)	$7.15	$24.50	243%
Insurance (life, hospital, surgical, medical, etc.)	7.10	24.50	245
Pensions (nongovernment)	7.73	20.00	159
Paid vacations	7.69	17.35	126
Paid holidays	4.69	10.63	127
Paid rest periods, coffee breaks, lunch periods, etc.	5.38	10.06	87
Unemployment compensation taxes	1.15	5.17	350
Workers' compensation	1.58	4.96	214
Paid sick leave	1.56	4.69	201
Profit-sharing payments	1.65	4.19	154
Dental insurance	N.A.	1.60	N.A.
Thrift plans	0.31	1.54	397
Short-term disability	N.A.	1.25	N.A.
Christmas or other special bonuses, suggestion awards, etc.	0.67	1.19	78
Salary continuation or long-term disability	N.A.	1.12	N.A.
Employe education expenditures	0.15	0.88	487
Employe meals furnished free	0.25	0.46	84
Discounts on goods and services purchased from company by employes	0.23	0.33	43
Other employe benefits	1.63	3.79	13?
Total employe benefits	$48.92	$138.21	183%
Average weekly earnings	$158.85	$379.79	139%

N.A. Data not available

TABLE 2

Employe Benefits Costs by Industry, 1982

	Per employe Per week
All industries	$138.21
Manufacturing:	
Petroleum industry	236.94
Primary metal industries	189.08
Chemicals and allied products	183.67
Stone, clay and glass products	171.33
Machinery (excluding electrical)	170.15
Transportation equipment	166.29
Fabricated metal products (excluding machinery and transportation equipment)	149.23
Food, beverages and tobacco	143.12
Printing and publishing	138.77
Pulp, paper, lumber and furniture	137.31
Rubber, leather and plastic products	133.06
Electrical machinery, equipment and supplies	130.71
Instruments and miscellaneous manufacturing industries	115.73
Textile products and apparel	88.92
Nonmanufacturing:	
Public utilities (electric, gas, water, telephone, etc.)	185.63
Miscellaneous nonmanufacturing industries (research, engineering, education, government agencies, construction, etc.)	135.35
Insurance companies	124.75
Banks, finance companies and trust companies	110.46
Hospitals	102.02
Trade (wholesale and retail other than department stores)	90.50
Department stores	65.75

Source: EMPLOYEE BENEFITS 1982, CHAMBER OF COMMERCE OF THE UNITED STATES, Washington, D.C., 1984, Tables from Nation's Business, April 1984.

Table 5
WEEKLY EMPLOYEE BENEFITS, per EMPLOYEE 1/
GROUPED BY TAX TREATMENT

	1971	1982	Percent Increase
TAXABLE BENEFITS 2/ (73% of total in 1982)			
Old-age, survivors, disability and health insurance (FICA taxes)	$7.15	$24.50	243%
Private Pensions	7.73	20.00	159
Paid vacations	7.69	17.35	126
Paid holidays.	4.69	10.63	127
Paid sick leave.	1.56	4.69	201
Unemployment compensation. . . .	1.15	5.17	350
Profit-sharing payments.	1.65	4.19	154
Short-term disability.	N.A.	1.25	N.A.
Thrift plans	0.31	1.54	397
Salary continuation or long-term disability	N.A.	1.12	N.A.
Paid rest periods, coffee breaks, lunch periods, etc. .	5.38	10.06	87
Subtotal	37.31	100.50	169%
II STATUTORILY NONTAXABLE BENEFITS (24% of total in 1982)			
Insurance (life, hospital, surgical, medical, etc.) . . .	7.10	24.50	245
Workers' compensation.	1.58	4.96	214
Dental insurance	N.A.	1.60	N.A.
Christmas or other special bonuses, suggestion awards, etc. . . .	0.67	1.19	78
Employee education expenditures.	0.15	0.88	487
Employee meals furnished free. .	0.25	0.46	84
Subtotal	9.75	33.59	245
III OTHER NONTAXABLE BENEFITS (3% of total in 1982)			
Discounts on goods and services purchased from company by employees	0.23	0.33	43
Other employee benefits.	1.63	3.79	133
Subtotal	1.86	4.12	122%
Total	48.92	138.21	183%
Average weekly earnings	$158.85	$379.79	139%

N.A.: Data not available.

1/ The data presented are from the Chamber's Annual Employee Benefit Surveys.

2/ Tax treatment varies.

* Taxable as of 1984.

Senator PACKWOOD. I'll give you a quick one-liner on day care. It's the best one I've run across in the past couple of weeks. A political candidate is opposed to day care, and his opponent says his idea of day care is that working women should live near their mothers. [Laughter.]

Let's now move on to a panel: Mr. Rogers, Jerry McKinney, and Merlyn Flaata.

Senator DURENBERGER. Mr. Chairman, I think, as I heard you introduce them, two of these panelists are from my State. It is not quite the same kind of panel you had yesterday from the State of Oregon, but let me just say that these people and as I recall maybe 25 other people similarly situated in Minnesota have come together several times. They got me to support the Packwood-Conable approach, and they have been doing a lot of work back there to try to be helpful in the long term to you and to this committee in the area of fringe benefit taxation, and particularly the flexible benefit plans. So I look forward to hearing from them.

Senator PACKWOOD. Thank you. Yesterday I made the point: Not only do we need the CEO's from General Motors to call us, but equally important is the Mason Corp. of this world talking to their particular Member of Congress to say, "Let me tell you what this is going to do to 3-400 of your constituents in this district." That will often be more influential than all the other lobbying put together.

Mr. Rogers, why don't you go ahead.

STATEMENT BY CHARLES W. ROGERS, CHAIRMAN, BOARD OF DIRECTORS, EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION, WASHINGTON, DC, ACCOMPANIED BY WILLIAM W. CHIP, ESQ., IVINS, PHILLIPS & BARKER, WASHINGTON, DC

Mr. ROGERS. Good morning.

Today I am speaking on behalf of the Employers Council on Flexible Compensation. There are 155 member-companies in that organization, and those companies provide welfare and retirement benefits for over 15 million employees and dependents in this country.

The Employers Council on Flexible Compensation's primary interest, I think, in the whole area of indirect compensation is to have the freedom to act in terms of our franchise agreement with the Government.

Over the years the Government has provided and decided to provide health and welfare coverage and pension coverage for the indigent and the needy. And I think you have made an agreement with private industry, a franchise agreement, that we in the private sector would provide for working America.

Senator Packwood, earlier you mentioned the amount of tax legislation that has taken place over the past 4 or 5 years, and I would say during that period of time you have continually—not you, but Congress has continually—redefined that franchise agreement. But I think you have redefined it in ways that are very difficult for American industry to adjust to.

I heard earlier mention of Assistant Secretary Chapoton's statement yesterday, and as a practitioner and as a business manager in this area I have to tell you that I compare my facts and experience in managing a multimillion dollar benefit program for several thousand employees with his projections and assumptions, and something doesn't match up.

For example, I can tell you that at Pepsico when we converted to a flexible compensation program and added one of those cash-back reimbursement accounts, more than half of our employees voluntarily elected to take less indirect compensation, health and welfare benefits, than we had provided before. And the coverage that we had provided before was at best average as compared to the consumer products industry in this country, which is not a generous industry insofar as indirect compensation is concerned. But when I compare that fact and that experience with an assumption that if you provide people with the opportunity to purchase more coverage, they will automatically do so, it just doesn't align.

There are several other companies—Bethlehem Steel—and these are member companies of the ECFC—LTV, Armco, Quaker Oats, Xerox, American Can—with several thousand employees who have used either flexible-benefit programs or reimbursement accounts to cut back on and increase the level of employee cost sharing in their indirect compensation programs, I think industry recognizes that the Chrysler programs with $6,000 a year are not tenable for us. We are trying to adjust and introduce cost sharing to our employees.

Having the flexibility in the Tax Code for us to make the right business decisions I think is critical, and I think you need to be very careful through the legislative process as you enter 1985 not to take the tools away from us that we need to exercise our franchise effectively.

Thank you.

Senator PACKWOOD. I want to thank you for getting that Pepsico information for me. I have used it many times in speeches. It is a perfectly good example of a major company and what will happen given this alternative. The Government, at least if your example is accurate, is going to pick up money, in addition to everything else.

Mr. ROGERS. It did, this year.

Senator PACKWOOD. Mr. McKinney.

[Mr. Rogers' written testimony follows:]

ecfc **Employers Council on Flexible Compensation**
Suite 600 • 1700 Pennsylvania Avenue, N.W. • Washington, D.C. 20006 • Telephone (202) 393-1728

Summary of the Testimony

of Charles W. Rogers on behalf of the

Employers Council on Flexible Compensation

Before the Subcommittee on Taxation and Debt Management

of the Senate Finance Committee

July 27, 1984

1. Cafeteria plans allow employees to choose between different packages of nontaxable benefits. Employees who choose the less expensive packages receive the savings in the form of additional compensation, which is taxable.

2. Employers offer cafeteria plans because benefits have become too costly to provide each employee the same package of benefits without regard to whether the employee really needs those particular benefits.

3. When PepsiCo implemented a cafeteria plan, 55% of employees chose a <u>less</u> expensive package of benefits than previously provided by the Company. Only 21% chose to increase their coverage. These results are not uncommon and are the major reason why employers are excited about cafeteria plans as a tool for controlling benefit expenditures.

Testimony of the Employers Council on
Flexible Compensation before the
Subcommittee on Taxation and Debt Management
of the Senate Finance Committee
July 27, 1984

Thank you for the opportunity to testify before this Subcommittee on the subject of employee benefits. The Employers Council on Flexible Compensation is an association of major employers with an interest in cafeteria plans and other forms of flexible compensation for their employees. Our 155 member companies provide welfare and retirement benefits for over 15,000,000 employees and dependents located in every state in the country. A copy of our membership list is attached to our written statement.

Employers are moving in the direction of flexible compensation because our workforce has become more diverse. In the 1940's employers designed a package of benefits for what was then the typical worker -- a middle-aged male who was the sole support of his family. Two things have changed since then. First, the cost of that standard package of benefits has risen dramatically. Second, the workforce has become more diverse, and there is no longer a "typical" worker. Given the high cost of benefits, employers can no longer afford to provide the same package of benefits to each employee without regard to whether the employee needs those particular benefits.

Let me give you a concrete example. Most employers provide group term life insurance for their employees. An employee with a dependent spouse or children will in most cases need more life insurance coverage than an employee with no dependents. If an employer does not have a flexible compensation plan, he will probably provide the same level of group term life insurance coverage for all employees, with the result that the employee with dependents will end up with less insurance than he needs and the employee without dependents will end up with more insurance than he needs.

Another example is the family in which both spouses work. The husband may have medical insurance from his employer that covers his entire family, including his wife. At the same time, his wife may be receiving medical insurance from her employer that duplicates what the husband's employer is providing. In a cafeteria plan, the wife can elect to forego medical insurance and instead receive additional cash compensation or some other benefit, such as dependent care assistance.

In a flexible compensation plan, we offer different packages of benefits to our employees and let each employee choose the package best suited to his or her needs. The cost of one package of benefits may exceed the cost of another package by several thousand dollars, and we pass on the savings to those employees who choose the less expensive package. The employee receives the savings in the form of additional cash compensation on which he pays income and social security taxes.

From a revenue perspective cafeteria plans can only be harmful if employees take advantage of such plans to increase their nontaxable benefits. We believe that this will not happen in a qualified cafeteria plan. First, beginning next year, the nontaxable welfare benefits that may be offered under a cafeteria plan are limited to accident and health benefits, group term life insurance, and dependent care assistance. Except for dependent care assistance, most employees already enjoy a high level of medical and life insurance protection. Second, in determining the appropriate "mix" of cash compensation and benefits, an employer who does not maintain a cafeteria plan will have to balance the needs of employees who want more benefits with the needs of employees who want more cash and will be forced to provide a level of benefits that is less than what some employees want and more than what others want. When the same employer implements a cafeteria plan, some employees will elect more benefits than previously provided and some employees will elect fewer benefits, but the average amount of benefits elected should not change much because the pre-cafeteria-plan benefits were already an "average" of what these employees wanted.

It is the experience of most cafeteria plan sponsors that, on the average, employees do not choose more nontaxable benefits under a cafeteria plan than they received before the plan was implemented. Take the case of my own company, PepsiCo, Inc. We adopted a cafeteria plan in 1982 and offered our employees the opportunity to elect more benefits, the same benefits, or fewer benefits. Keep in mind that our industry, the food processing industry, has not traditionally provided the high level of benefits enjoyed by auto industry workers and others. There was therefore ample room for our employees to increase their level of benefits. Nevertheless, <u>55%</u> of our employees opted for a benefit package that was <u>less</u> expensive than what they had previously received. Twenty-four percent opted to keep the same benefits as before, and only 21% chose to increase their benefits.

During the last decade, the cost of welfare benefits, whether provided by the Government or by employers, has risen dramatically. Employers have as great an interest in controlling these costs as does the Federal Government. While the Federal Government may lose twenty-five cents in revenue for each additional dollar spent on welfare benefits, employers lose more than fifty cents in after-tax profits for each dollar of benefits provided. I can assure this subcommittee that employers do not offer cafeteria plans in order to spend more money on welfare benefits. On the contrary, cafeteria plans provide an opportunity to educate our employees on the high and rising costs of these benefits and to limit benefit expenditures to the minimum amount necessary to provide adequate protection to those employees.

EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION
July 24, 1984

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STATEMENT OF JERRY McKINNEY, VICE PRESIDENT, PERSONNEL, NORTHERN STATES POWER CO., MINNEAPOLIS, MN

Mr. McKINNEY. Thank you very much.

I am vice president of personnel for Northern States Power Co., a midwestern utility based in Minneapolis. We have 7,200 full-time benefit employees serving over 1.5 million customers of gas, electric, and telephone in a five-State area. Approximately 3,300 of our employees are represented in a collective bargaining situation by the IBEW.

First of all I would like to start off by echoing the comments that Mr. Garrett made that we could no longer talk about "fringe benefits," but more, "employee benefits." At NSP, the benefits are costing NSP approximately 40 percent of our direct labor costs. While this may be high compared to the general industry, it is not high in the utility industry, and this comes about as a result of the demographics of employees in the utility industry. The average age of our employees is a little over 41; the average length of service is over 18 years, and our turnover for last year was only 3.5 percent. So there is a focus on benefits which are seniority related or time related in terms of their situation.

Now, I might add that these high benefit costs have not gone unnoticed by outside people. Being a utility, we do have to go before the utility commission for any rate increases. The last time we went in for electric rate increase in the State of Minnesota they had numerous inquiries in regards to who we were comparing ourselves with in terms of benefits, why were our benefit costs so high, why was our nonproductive time high. And I think it is going to continue. It has been proved in other States where the public utility commissions specifically—in five instances that we can recall—came out and told the utilities, "If you want to increase your benefits and compensation at this rate, that's fine; but you are not going to pass it on to the ratepayer. And this is what we see as a fair and equitable amount for you in terms of your rate increases." So we are going to be very sensitive to the labor costs and particularly to the employee benefit costs.

Our benefits developed largely out of the collective bargaining process over the past 35 years, and we are not particularly sensitive to the tax laws and the tax incentives. The union has focused in on the pension, and of course medical care and a full-type program like that, with little emphasis for example in the area of life insurance or a savings program.

We really didn't pay too much attention to some of the tax laws and tax incentives until we had the opportunity to participate in the ESOP program 7 years ago, and then 4 years ago we initiated a cafeteria program, taking advantage of some of the incentives not only for the company but for the employees.

As a result of how our program has developed, we do not favor the highly paid executives but are looking at the overall employees in general.

Furthermore, I think that we as an employer can provide employee benefits more economically than the Government. We have numerous self-insured, self-administered type programs. We are saving the money which would normally be passed on to a third party for profits that they must make in order to administer various benefit programs. We are saving any costs that might be established or be tied up in reserves. And in terms of the individuals, as was commented earlier, we have the opportunity for greater purchasing power; we can offer some benefits which are not normally offered on an individual basis, and in some cases we are actually taking the uninsurable because we have a broad base or because of the personnel policies that we have that we will take everybody if they are acceptable for employment.

We think the favorable tax laws have been beneficial, at least in terms of our cafeteria program; but, in summary, we would like to say we think it is important that the tax law is not changed drastically, that there is definitely an economic security of the employees which is dependent on benefits, and that if there are some changes in the tax laws which take away some of these benefits or don't make it quite as attractive for the employer, then we feel it is going to probably fall back on the Government, because, simply, the ones most likely to be affected are the lower paid employees or the employees who have the least amount of seniority with a particular company.

Thank you for the opportunity to be here.

Senator PACKWOOD. Mr. Flaata.

[Mr. McKinney's written testimony follows:]

Presentation

by

Jerry McKinney
Vice President - Personnel
Northern States Power Company

for

Finance Subcommittee on Taxation and Debt Management
Hearing on Fringe Benefits
July 26, 1984

My name is Jerry McKinney, Vice President of Personnel for Northern States Power Company, a Minneapolis-based electric and gas utility with approximately 7,200 full-time benefit employees. We serve over 1.5 million customers in a five-state area and had revenues of $1.7 billion in 1983. Approximately 3,300 employees are represented by the IBEW.

The main points I wish to cover in my presentation are:

1. NSP is sensitive to the total labor costs for its employees, direct compensation and employee benefits.

2. The current benefit program at NSP was developed largely out of demands made in collective bargaining negotiations over many years.

3. Tax laws and tax benefits to NSP as an employer have had a minimal impact on the design of employee benefits.

4. The benefit program at NSP does not favor the highly-paid executives.

5. NSP can provide benefits for its employees at a lower cost than if provided by the government or individually by the employee.

6. Favorable tax laws encourage flexible benefits, which in turn reduce costs to NSP. This has a favorable impact on our customers.

I would like to begin by saying that subject "fringe benefits" should more appropriately be labeled "employee benefits." Benefits provided by NSP approximate 40% of our direct labor costs and, as a result, have a sizable impact on our total employee costs. Our benefit costs, which are on the high side for general employers, are average for utilities. This occurs in the utility industry because of the demographics of our employees. The average age of our pension plan participants for 1983 was 41.1 years, and the average length of service was nearly 18 years. The turnover of full-time benefit employees is less than 3.5% per year. These demographics have the biggest impact on our pension and vacation benefits.

This high cost for employee benefits did not go unnoticed by the Minnesota Public Utilities Commission during our last rate hearings. They raised several questions and we were able to provide satisfactory answers to their concerns. However, their concerns have increased the sensitivity of top management to carefully manage benefit design changes and future costs.

NSP has negotiated with the IBEW for over 35 years for wages and benefits. The influence of these negotiations has had considerable impact on the design of benefits at NSP. Until 1982, our primary market comparison for benefit purposes in negotiations was the 15 major utility companies in the U.S., and 16 utilities within a 500 mile radius of Minneapolis-St. Paul. Then, beginning in 1982, we shifted our market comparison to the major Twin City employers. The major emphasis by the union has been in the areas of time off, pension, disability and comprehensive medical care. Very little emphasis, for example, has been placed on life insurance--only $10,000 in non-contributory benefits is provided for the active employee and $4,000 for the retired employee. We have no matching savings program, however we did introduce a 401(k) program for union employees in 1983. We experienced 36% participation, without any match, so it is obvious that the employees are beginning to recognize the tax value of this benefit--plus, they are interested in supplementing their pension benefits.

The tax laws and tax benefits for NSP as an employer have had a minimal impact on the design of benefits, up until the inception of our cafeteria benefits program in January, 1981. The cafeteria program is available to only non-union employees. We have made it known to the union management that cafeteria benefits could be a negotiable item, however they have shown no interest during the last five years. We did take advantage of the ESOP provisions when first made available and currently have a PAYSOP program. The primary driving force, however, in the design of benefits was the demands of union employees, as mentioned earlier, and not what tax benefits the company could derive as an employer.

The design of employee benefits at NSP does not favor the highly-paid employees, as a result of the unions' impact on benefits during negotiations at NSP. In fact, the only benefits currently available to the highly-paid employees are free parking for 19 officers and a non-qualified deferred compensation plan. Otherwise, the highly-paid employees have the same benefits as all other employees. The average deferral percentage under the 401(k) program has been:

Level	1984	1983
Upper 1/3	5.1%	4.6%
Lower 1/3	2.7%	2.5%

The highly-paid employees have the same life insurance and medical benefits after retirement as do the lower-paid employees. The lack of executive perks has, at times, been a detriment to recruiting efforts of executives outside the utility industry.

I feel that NSP can administer and deliver employee benefits at a lower cost than if provided by the government or purchased individually by employees. Currently, we are self-insured and self-administered for medical benefits. As a result, we are able to personalize some of the relationships with users (our employees), while at the same time experience turnaround time on claims comparable to insurance claim administrators--and, at a lower cost per claim. We have a minimum premium dental plan which is administered cost effectively by a service organization. In both instances, there are no unnecessary and costly insurance company reserves established, nor is a profit being paid to a third party for administration. The $4,000 retiree life insurance program is self-insured and self-administered. The $365 million pension fund is administered by eight fund managers selected by the company for their high performance, which helps keep our contribution levels down. When compared to the complex and costly administration of the social security system and medicare, I feel private industry can administer the benefit programs for their employees far more effectively--and, at a lower cost than government entities.

When one compares the cost of individually purchased benefits vs. group plans, the cost is substantially in favor of group plans. Group plans spread the risks among large groups of people; many times they will insure the uninsurable, and group purchasing power is beneficial--regardless of the type of product a company buys. In addition, some benefits are impossible or nearly impossible on an individual basis. Examples might include dental insurance, long-term disability, matching savings programs and pre-tax savings programs.

The current tax laws have had a major impact on the design of benefits at NSP since the inception of our cafeteria program in January of 1981. The program is currently available to 3,600 non-union employees.

The cafeteria benefits program has allowed us to provide individualized plans which are responsive to the needs of our employee population on a cost effective basis. The result has been a shifting of benefits to satisfy individual employee needs, without additional costs for benefits to the company. For example, we added child care benefits at no cost to the company.

The tax incentives in the cafeteria program--prior to the recent interpretations by the IRS--were attractive to the individual employees. The participation in the reimbursement accounts for 1984 is as follows:

Health care	47%	$397	average	deposit
Child care	5%	$1,180	"	"
Legal	9%	$234	"	"

Approximately 95% of the employees used pre-tax dollars to pay for dependent coverage for medical and dental benefits. Employees who purchased additional disability benefits used pre-tax dollars for 66% of the total premium, despite the fact that the disability benefit received then becomes a taxable income. In the non-matching savings program we experienced a participation level of 79%.

The employees at NSP also have an option to buy or sell vacation time. There is no tax incentive for the employee in buying vacation, it is merely a mechanism for the employee to re-distribute the cost of taking unearned vacation with pay from his/her total annual pay. The selling of vacation time can result in a temporary tax benefit, or it may only be a re-distribution of employee benefits.

It is important that the current tax laws and tax incentives for employees and employers not be drastically changed. The economic security of employees and retirees is contingent upon employee benefits. The lack of many current benefits (provided by employers) would most likely place a large financial burden on all levels of governmental agencies to provide financial assistance to millions of low income families. This requirement for additional government funds would require greater income taxes to be paid by the employees and employers.

We at NSP strongly support the continuance, at a minimum, of the current tax laws and tax incentives. Changes by the government--in an attempt to increase tax revenues--could possibly end up costing the government more.

I appreciate the opportunity to discuss the issues of taxes and benefits with this Subcommittee, and will be interested to hear about the results of these hearings.

STATEMENT OF MERLYN R. FLAATA, VICE PRESIDENT, EMPLOYEE BENEFITS, FIRST BANK SYSTEM, INC., MINNEAPOLIS, MN

Mr. FLAATA. Good morning. I am Merlyn Flaata, vice president of employee benefits for First Bank System.

First Bank System is a bank holding company headquartered in Minneapolis. We have our primary service area of Minnesota, Montana, North and South Dakota, and Wisconsin, with approximately 10,000 employees.

We believe that we have the responsibility not only to the employee but also to the community to ensure that all employees have adequate resources to deal with certain life events. But at the same time, we realize that we have a responsibility to our shareholders to contain these expenditures to a reasonable level. And we do this by offering a package of benefits which we consider average in value when compared to the competition.

On January 1, 1984, we offered our employees a flexible benefits program to help with their varying needs and also to get better cost control of our benefits. To give you an idea of our demographies, 70 percent of our employees are females, 30 percent male, 31 percent are single or single parents, and 53 percent are married with a working spouse, and only 16 percent are married with a spouse not working outside the home.

I feel that the original concept of benefits was set up for that 16 percent, recognizing only one wage earner in the family. The flexible benefit program really addresses our changed mix of employees.

The new plan and an accompanying 401(k) plan have been well received by our employees. Ten percent of our employees elected a lesser health care plan, indicating that we had been providing more coverage than necessary for that group. Employees are also saving approximately $12 million annually under the 401(k) plan compared to the $7.5 million under our previous profit-sharing plan.

We urge that laws continue to permit favorable treatment for reasonable benefits for all employees, and we urge you to support the following:

Encourage expansion of flexible-benefit programs We see that as a bit of cost shifting, how we can shift some of the costs to the employees but still allow the employees the advantages of the tax deductions that the employer has.

We would also be willing to go along with a realistic cap on health care coverage, if necessary.

We like continued support of 401(k) plans, but with clear definitions of withdrawals to avoid the younger employees shying away because they can't get at the funds.

We also would like to see a reduction of compliance rules. We feel there are a lot of rules that are set up only for the smaller employers that are applied to larger employers and create a lot of unnecessary expenses.

We would also like to see reconsideration of the carryover/cash-out rules for reimbursement accounts as a cost containment issue.

We also prefer to allow employees to buy and sell vacations and have a limited vacation carryover but now cannot as they are affected by recent legislation.

The legislative and regulatory bodies should strive to simplify rules regarding benefits and to develop a well-defined but stable environment within which private industry can administer employee benefit programs.

The need for financial protection of unexpected expenses and savings for retirement has not changed since benefits were granted a tax favored status. We urge continuation of this tax-favored status to help avoid employee dependence on welfare for protection no longer affordable by either the employee or the employer.

[Mr. Flaata's written testimony follows:]

STATEMENT

BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF MERLYN R. FLAATA,

VICE PRESIDENT, EMPLOYEE BENEFITS

FIRST BANK SYSTEM, INC.

JULY 27, 1984

Mr. Chairman, thank you for the opportunity to testify before this Subcommittee on a matter of extreme interest to First Bank System.

First Bank System is a bank holding company headquartered in Minneapolis with a primary service area of Minnesota, Montana, North Dakota, South Dakota and Wisconsin. We have approximately 10,000 employees.

In 1982, we began a Total Compensation Study. During the course of the Study we developed a statement of objectives for our Employee Benefits program. A summary of these objectives follows:

- That compensation will be made available to employees in the form of benefits when one or more of the following apply:

  - The corporation feels a responsibility to either the employee or the community to ensure that the employee will have adequate resources to deal with certain life events.

  - It is financially advantageous to the employee and the organization to do so (e.g., group purchasing power).

- It is consistent with other business objectives of the corporation.

• That employees be provided with credits (in addition to direct pay) to secure a package of benefits which is average in value when compared to competition.

• That a minimal level of required coverage will be designated as the core coverage and will not be optional.

• That beyond the core coverage employees should control whether compensation is taken as cash or as benefits.

• That employees have the opportunity to utilize their direct pay to secure benefits if they desire greater levels of protection.

The objectives clearly reflect our concern about rising employee benefit costs, especially when faced with deregulation of the banking industry. It is our intent to provide an adequate level of coverage based on individual employee needs, and to share cost increases with employees. We also feel it's important to encourage employees to save and to provide a vehicle for that purpose--our 401(k) salary reduction plan.

We have taken several steps in the last two years to help us reach our objectives.

1. Eliminated first dollar health care coverage.

2. Implemented a flexible benefits program in which employees can select individualized coverages according to need.

3. Implemented a 401(k) Salary Reduction Plan under which the company will match half of the employee contribution up to 6% of salary, which encourages all employees to save.

Our decision to convert our Health Care Plan from first dollar coverage to a Comprehensive Plan was the result of a 30% increase in cost to fund anticipated claims for the following year. This change reduced our cost increase to 20%, or a savings of $1,000,000.

While we see this action as cost shifting, we also believe it will help reduce overall health care costs by giving the employee an incentive to use less expensive services and products. The greater the expense, the greater the employee's co-payment.

Our Flexible Benefit plan allows employees to select coverage to fit their needs. A recent survey of our employees revealed that 70% are female and 30% male; 31% are single or single parents, 53% are married with a working spouse and only 16% are married with a spouse not working outside the home. These demographics quickly point out that a variety of levels are required within each benefit plan to satisfy the individual needs of these employees. Our Flexible Benefits plan was implemented on January 1, 1984 and has been extremely well received by employees.

The Health Care plans allow selection from among four Comprehensive plans, which vary by the amount of the deductible. We also permit employees to establish reimbursement accounts from which expenses not covered by our Health Care and Dental Care plans could be paid. Of significant interest to us was that 10% of our employees elected a greater deductible than our $100 deductible plan which was our standard plan in previous years--an indication that we were providing more coverage than necessary for these employees.

Various options are also available for Long-Term Disability protection, Life Insurance and Dependent Life Insurance.

We also believe that employees should be entitled to a reasonably adequate income at retirement based upon their salary and length of service with the Corporation and that cost-of-living adjustments for retirees are very expensive and should be allowed at the employer's discretion, but not mandatory. Employees must be educated as to their role in providing for supplemental retirement benefits and informed of the tax effective vehicles for such savings. IRA's and 401(k) plans are excellent examples of tax effective vehicles for encouraging savings. However, even these are tarnished somewhat by the fear of younger employees that the regulating bodies may further restrict access to a portion of these savings for critical financial needs. Employees and employers must have a guaranteed stable and well defined legal and tax environment to allow for proper benefit planning.

The employee benefit program is extremely important to our employees. Based on our recent survey, our employees rated the importance of benefits at 4.7 on a 5 point scale. Current tax laws permit us to continue providing a reasonable level of coverage. If the deductibility of these expenses was no longer permitted or substantially curtailed, we would find it necessary to reduce our expenditures and the benefits provided accordingly.

Tax laws should encourage employers to provide fringe benefits by allowing the deductibility of expenses paid for a reasonable level of coverage. Cost containment issues for corporations such as ours will have the effect of stabilizing expanded benefit prcgrams and cost sharing of existing benefits by employees. It is only reasonable that the employee should have the ability to pay for the increasing expenses on the same basis as his/her employer, in pre-tax dollars. Flexible benefit or cafeteria type plans should be encouraged for this purpose.

Caps may become necessary to eliminate flagrant abuse of flexible benefit plans in the areas of Health Care related plans and reimbursement accounts. However, such caps must be carefully set to avoid a substantial cost shifting to the employee.

We are also concerned about the forfeiture requirement in reimbursement accounts and the "no carry-over" rule for vacation if the employee is allowed to buy and sell days as a flexible benefit option.

Our flexible benefits plan, which was effective January 1, 1984, includes a Healthcare Reimbursement account and a Childcare Reimbursement Account. Approximately 2,800 employees enrolled in the Healthcare Reimbursement Plan on the effective date. Except for cash out/carry-over of remaining balances at year-end, our plan qualified under the proposed IRS Regulations. In view of the recent IRS posture we felt we had to allow our employees a new election for the last seven months of 1984 with a forfeiture at year-end. This required change frustrates our intent to involve employees in the effort to hold down medical expenses. As an example, only 800 employees elected to continue to participate for the last seven months. It seems clear that more employees will elect more expensive Health Care coverage rather than cover a higher deductible with a reimbursement account and risk forfeiture if not used. I also anticipate that employees will use their entire reimbursement account balance, even for unessential service, rather than forfeit, thereby driving up total health care costs.

We also permitted employees to buy or sell up to 5 days of vacation. In addition, we previously allowed employees to carry-over up to 5 days vacation into the first three months of the following calendar year. The new proposed regulations prohibit carry-over if both purchase and sale is allowed. I am concerned about employees who plan on vacationing near year-end and for business reasons the employer requests a delay. Our purpose for the carry-over is certainly not to defer compensation, but to assure employees of their earned vacation.

First Bank System is concerned about employee benefits, both as a business expense and to provide adequate protection for all employees. We are also concerned about the high cost of compliance. When cost and complexity of compliance becomes too great, our course has to be to cut such coverages or withdraw altogether. I hope that private industry can participate with the legislative and regulatory bodies to develop a well defined but stable environment in which we can reasonably administer employee benefits programs.

Senator PACKWOOD. I have no questions.

Let me state again the reason for these hearings. I realize not many Senators are going to come; but by the time we are done with these hearings, we will have a record that will show the argument that these plans are abused is a specious one. They are abused by very few people, and we can correct it; that is no problem.

Indeed, the benefits that are provided, with very few exceptions, are benefits that most fair minded people will say are benefits to which people are entitled, whether the Government does it or business does it. There wouldn't be much quarrel to that.

I think the record will show that business does it better than Government and cheaper than Government, and probably more responsively to their employees' needs than Government does. If we have a Government benefit program, it is going to be the same whether you live in Minneapolis or Moline. It doesn't matter that the areas are different or that the demographies of your businesses are different; you will have the same plan every place.

Now, with all of that, and hopefully with proper lobbying, we will be able to reverse what has been a very adverse economic/philosophic opinion about employee benefits for the past 2, 3, 4 years, and it is getting worse rather than better. If President Reagan or by chance Vice President Mondale is elected, and they continue this philosophy with an adverse Treasury Department, and an adverse House—which is what we have at the moment—we will continue to swim upstream.

I have no questions.

David.

Senator DURENBERGER. Well, I think, Bob, the point in what you said is to make sure that you have a system in which they do it better than we do it; and that's why it strikes me that, getting back to the fixed-broke argument and so forth, there was a time when, before flexible compensation, before we started involving our employees in making choices, before we started asking them to contribute a little bit to that choice, there was a point in time in which it was a lot more "broke" than it is today, and it was breaking the rest of the system.

I don't know if you recall what Mr. Flaata said about the demographics of at least the First Bank System work force, but it is impressive to find out that we have designed an insurance system—or it has been designed—that really applied to only 16 percent of the people; that is, the employees with a spouse not working outside the home. And it ends up now that we look and only 16 percent of the people fall into that category that we thought everybody fell into, and we had put together programs for that 16 percent.

But there is no way Treasury can recognize that, you know? Treasury does not believe that people, when given a choice, will buy less in health care coverage, or that they will use their noodles. And they cannot factor that into these statistics.

Senator PACKWOOD. But actually it makes sense. You don't need the more expensive program you used to have, so you choose a lesser program. You get cash for it, you pay tax on the cash, but you still have more cash than you had under the old program for benefits you didn't use. It makes sense when you think it through to its conclusion and my hunch is that the employee has thought it through to its conclusion.

Senator DURENBERGER. I don't think there is any question.

I just have one other question of the three of these witnesses, and it deals with the Chrysler example I raised before, the first-dollar coverage, whichever one of these benefits you are talking about. Tell me if there isn't some difference in the overall value of employee choices when they are contributing something financially to that choice. Or is that not a correct theory?

Mr. McKINNEY. I think maybe I could comment on that. The Rand study, which was concluded late last year, definitely showed that as you increase the participation by the participants that the utilization of the health care services went down, and in those programs where they had 100 percent payment of health care services, utilization was far higher than it was in the other cases. It is very conclusive from that study.

Senator DURENBERGER. Do you find that from your own experience at NSP, when you went to some cost sharing on your health benefit plan?

Mr. McKINNEY. Very definitely. I am not sure whether the employees who selected the highest deductible available were aware ahead of time what their costs were, but their costs at the end of the first year and at the end of the second year were very clearly a lot smaller than those people who had elected a zero deductible and were willing to even pay more than what we had originally started out with for their health care coverage.

Senator DURENBERGER. Isn't it also true that once you introduce two choices of health plans or three choices of health plans, employee choice gets even better, providing the employer stays neutral in their financial contribution and does not try to leverage that choice one way or another? Is that not also a fact?

Mr. ROGERS. In fact, I think most of the flexible benefit systems have been drawn up on that basis, that it is really critical if you are going to control health care costs over time to create a mutuality of interest with your employee in terms of the costs that they incur.

One of the other things that you will see developing in American industry today as well are very aggressive education programs so that we can help our employees learn how to be better consumers of health care. And it is critical that you add that leg onto it, because, "It's fine that you have made me participate in the cost, but I am not sure that I understand exactly how I can be more efficient in using the health system."

Senator, you may be interested to know that through our flex program we have seen a fairly significant increase in participation in HMO's, for example, as employees saw that to be a more efficient system through which to purchase their health care. And they made that decision voluntarily.

So I think if you combine the education process along with the economic incentives, and create a mutuality of interest with employees, the combination of those things really is very promising in terms of being able to control health care costs over time.

Senator PACKWOOD. Gentlemen, thank you very much; I appreciate it.

Next we will take Marjorie Kopp, day care specialist, for Child Welfare League; and Carole Rogin, executive director of the National Association for Child Care Management.

Good morning. Do you want to go first, Ms. Kopp?

STATEMENT BY MARJORIE KOPP, DAY CARE SPECIALIST FOR GOVERNMENT AFFAIRS, CHILD WELFARE LEAGUE OF AMERICA, INC., WASHINGTON, DC

Ms. KOPP. Good morning. My name is Marjorie Kopp, and I work with the Child Welfare League of America.

The Child Welfare League is a privately supported membership organization of 350 child welfare service agencies, including public welfare departments and private not-for-profit agencies.

We also represent about 1,100 other child care agencies in the United States and Canada through our network of 27 State child care associations.

Thank you very much for the opportunity to come here today. I am here to call your attention to what we in the field are finding is a very unfortunate and counterproductive conflict between the Federal tax system and the Federal Government program initiatives to recruit employer-sponsored day care.

As you may know, over the past 4 years there has been a very strong emphasis on developing public-private partnerships in the human services field. What you may not be aware of is that child day care was one of the four areas of special concentration recommended by the 1981 President's Advisory Council on Private Sector Initiatives.

In response to this, the White House Office of Private Sector Intitiatives embarked on a continuing project to promote employer-sponsored day care. White House spokespersons convened meetings with chief executive officers of major corporations in cities across the Nation to apprise them of the opportunity and responsibility to strengthen American families and American productivity by offering day care benefits to their employees. One of the options presented at these meetings is flexible benefit plans. And according to a report this month from the Bureau of National Affairs, cafeteria plans have been one of the main reasons child care benefits have proliferated—that is, child care benefits sponsored by employers.

At the same time, the Department of Health and Human Services has also pursued employer-sponsored day care as one of the major initiatives, and has signaled the field of day care providers that this is the avenue to pursue.

According to the BNA report, employer support for child care has been one of the most widely-heralded developments in employee relations in the past decade, and the number of employers offering some child care benefits to workers has doubled since 1982.

Large employers, according to the report, are making increasing use of flexible benefit plans to provide child care benefits.

As you may imagine, the February 10, 1984, IRS press release announcing the intention to tax flexible benefit plans retroactively has had a very chilling effect on these initiatives. The Child Welfare League is concerned about these developments because we are concerned about the supply and the demand of child care.

As child serving agencies and child advocates, our members are in the position to see firsthand the damage which is done to children and families when appropriate child care is unavailable. We do not wish to see the presently inadequate supply of child care further eroded by mixed governmental signals and failed initiatives.

Child Welfare League members have responded to the challenge of this administration to find alternative funding for children's programs. We are interested in pursuing employer assistance to increase the supply of child care, especially in view of the demographic projection that during this decade the population of children under age 10 will increase by 14 percent. We therefore ask the committee to give renewed consideration to Senator Packwood's recommendation for safeguarding the dependent care benefits in employer sponsored cafeteria plans, under a cap and integrated with the dependent-care tax credit.

We do favor the proposal to index in order to assure that the benefit retains its current money value, since neither employers nor employees are inclined to support job benefit programs offering uncertain future value.

We also recommend some refinement of the situational exceptions to allow for changes in family circumstances other than those envisioned in the original list, and provisions for employees to take in the form of taxable income in the following year any benefits not used in the previous year.

We appreciate your interest, and we hope very much that you will find it possible to help us in our effort to increase the supply of care, adequate care, for the Nation's children.

Senator PACKWOOD. Thank you.

Ms. Rogin.

[Ms. Kopp's written testimony follows:]

CHILD WELFARE LEAGUE OF AMERICA, INC.
CENTER FOR GOVERNMENTAL AFFAIRS
1346 Connecticut Ave. NW, Suite 318, Washington, D.C. 20036 (202) 833-2850

TESTIMONY PRESENTED TO THE

TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE

of the

SENATE FINANCE COMMITTEE

On behalf of

THE CHILD WELFARE LEAGUE OF AMERICA

by

MARJORIE KOPP, DAY CARE SPECIALIST

CWLA CENTER FOR GOVERNMENTAL AFFAIRS

July 27, 1984

GUARDING CHILDREN'S RIGHTS • SERVING CHILDREN'S NEEDS

My name is Marjorie Kopp. I am a Day Care Specialist in the Child Welfare League of America's Center for Governmental Affairs. The Child Welfare League is a privately supported membership organization of 350 child welfare agencies whose efforts are directed to the improvement of care and services for children and families. League member agencies include public welfare departments and voluntary, private not-for-profit children's service organizations. The League also represents 1,100 affiliated child care agencies through our 24 state child care associations. Members and affiliated agencies of the League serve several million children in the United States and Canada, and represent over 6,000 volunteer board members and several thousand more direct service volunteers.

I thank the Committee for this opportunity to testify. I am here to call your attention to the unfortunate and counterproductive conflict which currently exists with respect to the federal tax system and federal government program initiatives to recruit employer assistance for child day care.

As you may know, over the past four years there has been a strong emphasis on developing public-private partnerships in the human services field. What you may not : aware of is that child day care was one of the four areas of special concentration recommended by the 1981 President's Advisory Council on Private Sector Initiatives. In response, the White House Office of Private Sector Initiatives embarked on a continuing project to promote employer sponsored day care. White House spokespersons convened meetings with chief executive officers of major corporations in cities across the nation to apprise them of the opportunity and the responsibility to strengthen American families and American productivity by offering day care benefits to their employees. One of the options presented at these meetings is flexible benefit plans, and, according to a report this month from the Bureau of Nation Affairs, Employees and Child Care: Development of a New Employee Benefit, "cafeteria plans have been one of the main reasons child care benefits have proliferated."

At the same time, the Department of Health and Human Services began revising its federal leadership role by directing HHS technical assistance and research and demonstration grants to the recruitment of employer sponsored day care.

According to the BNA report, "employer support for child care has been one of the most widely heralded developments in employee relations in the past decade, and the number of employers offering some child care benefit to workers has doubled since 1982. Large employers are making increasing use of flexible benefit plans to provide child care benefits. This approach is favored because is allows employees without children to select other benefits instead."

As you may imagine, the February 10, 1984 IRS press release announcing the intention to tax flexible benefit plans retroactively, and the May 7 proposed Cafeteria Plan regulations have had a chilling effect on these initiatives.

The Child Welfare League is concerned about these developments because of the effect on child care supply and demand. As children's service agencies and child advocates, our members are in a position to see first hand the damage which is done to children and families when appropriate child care is simply unavailable. We do not wish to see the presently inadequate supply of child care further eroded by mixed governmental signals and failed initiatives. Child Welfare League members have responded to the challenge to find alternative funding for children's programs and have established some workable public-private partnerships. We are interested in pursuing employer assistance to increase the supply of child care, especially in view of the demographic projections with respect to increasing demand. According to the Congressional Budget Office (Demographic and Social Trends: Implications for Federal Support of Dependent Care Services, December 1983) the population of children under age 10 is projected to increase by 14 percent during this decade, with children under age 5 accounting for two-thirds of the increase.

We therefore request that this Committee give renewed consideration to Senator Packwood's recommendations for safeguarding the Dependent Care benefits in employer sponsored cafeteria plans, under a cap and integrated with the Dependent Care Tax Credit. We are appreciative of your action in the Deficit Reduction Act to remove the proposed retroactive sanctions. We are hopeful that this means you understand the significance for children of encouraging employers to offer dependent care benefits.

We believe that placing an overall cap on the Dependent Care benefit and the Dependent Care Tax Credit together provides some guarantee that this will not be a runaway tax expenditure and revenue loss. We do favor the proposal to index in order to assure that the benefit retains its current money value, since neither employers nor employees are inclined to support job benefit programs offering uncertain future value. We also recommend some refinement of the situational exceptions to allow for changes in family circumstances other than those envisioned in the original list, and provision for employees to take, in the form of taxable income, in the following year any benefits not used in the previous year.

In the midst of all the very large tax and deficit issues which you will be dealing with over the months ahead, we hope that you will not lose sight of the need to encourage the newly generated interest of employers in investing in dependent care benefits, so that this resource will continue to be available to meet the increasing demand for care of the nation's children.

STATEMENT OF CAROLE M. ROGIN, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION FOR CHILD CARE MANAGEMENT, WASHINGTON, DC

Ms. ROGIN. Thank you.

I am Carole Rogin, executive director of the National Association for Child Care Management. Our members—to give you some background—are the private proprietary child care companies in the United States. I am here representing not only their interests in the service that they provide—licensed, quality, center-based child care in America—but also their interest in employee benefits as employers themselves. I do believe that they were perhaps the first and probably continue to be the largest group of employers who provide child care as an employee benefit, so we have had a great deal of experience in that area.

Additionally, since most of the companies were founded in the late sixties and early seventies, they have been working in cooperation with businesses, large and small businesses, corporations, and hospitals to provide child care as an employee benefit. At this point in time we have close to 100 of our members who report that they are currently involved in employer-related child care.

To give you a sense of the scope, just 4 of those members run 116 individual employer-assisted child care programs.

Senator PACKWOOD. When you say "employer-assisted," do you mean on site?

Ms. ROGIN. Absolutely not. These programs span the full range of programs. There are some that are onsite programs that have been conceived, developed, designed, implemented, managed and owned by our child care companies. There are programs such as programs at Disney World in Florida, Campbell Soup Corp., a number of onsite programs. The majority of programs are some kind of contractural arrangement between the child care company and the business, for the employer too in most cases, to obtain a discount on the average weekly tuition for his or her employees, and in return for the company to be able to offer some discount, too, that relates to really attractive savings for the parents. That is perceived and is actually a benefit of working for that particular company.

The need and the rationale for child care as an employee benefit, and we believe a very legitimate topic for discussion in any fringe benefit hearing such as this, have been discussed earlier today and I think are supported by what we see as—I think we all agree—dramatic and probably permanent changes in the nature of the U.S. work force. Our written testimony documents and there are statistics out there everywhere documenting the fact that ultimately the percentage of workers who are parents and the sole support of their families has increased dramatically in the United States.

The two things that we believe are absolutely essential to see this benefit enhanced and provided on a wider scale are education of businesses in this country to the options for funding the benefit, and education for businesses regarding the provision of the benefit.

We just talked briefly about the options for providing the benefit, and I think employers also need to know that this is a benefit whose cost can be controlled directly. It is not a benefit that needs to be funded at 100 percent of its cost to be perceived as a valuable benefit by the employees.

So we would see that those two factors are the most important ones. We see two substantial differences between child care and the more traditional employee benefits—the fact that child care addresses current neéds perhaps more directly than many benefits that we can talk about, and its costs can be controlled by the employers more completely than virtually any benefit available.

Thank you.

[Ms. Rogin's written testimony follows:]

TESTIMONY

BEFORE THE SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

PRESENTED BY

CAROLE M. ROGIN, EXECUTIVE DIRECTOR

NATIONAL ASSOCIATION FOR CHILD CARE MANAGEMENT

The National Association for Child Care Management (NACCM), representing the private, proprietary providers of center-based child care, appreciates the opportunity to participate in the hearing today. On behalf of the NACCM membership, I am pleased to share our members' perspective on the vital need to recognize child care as an important employee fringe benefit topic.

As background for you, the 300 NACCM member companies - ranging in size from one child care center that is owned and operated by a single individual to companies that operate hundreds of centers nationwide - are in the business of providing licensed, quality child care to approximately 200,000 of America's children in center operations throughout the country. Many of the 300 NACCM member companies have been in the employer-sponsored child care business since the early 1970's and continue to create and provide more diverse services that will contribute to increased partnerships between the business community and the child care industry. In 1984, over 76 NACCM members report participation in some type of employer-related child care program with corporations, hospitals, and small or large businesses. For example, just four of NACCM's members - Childrens' World, Inc., ECLC, Inc., Gerber

Children's Centers, Inc., and Kinder Care Learning Centers - operate 116 employer-related child care programs. These programs span the array of options from one-site centers that are owned and managed by the child care company to contractual agreements between employers and the child care companies for a specific number of children in a selected center.

As a result of the major and probably permanent changes in the complexion of the U.S. workforce, employer-related child care is emerging as <u>the</u> fringe benefit of the 1980's. For the first time in history, an unprecedented number of parents are currently working or seeking employment. Statistics indicate more than half of all children in two-parent families had mothers who were working. Among single parents the proportion where the parent's earning was the sole support for the family was even higher. Another major factor influencing the evolving workforce is the large number of women who are entering and/or remaining in the workforce. Not only have expanded opportunities for women resulted in an increase of two-career families but the reality of today's economic situation has dictated the need for two paycheck families in order to even come close to realizing a significant number of aspirations for themselves and their children. Additionally, the spiraling divorce rate has greatly increased the number of one-parent families.

Consequently, traditional benefit programs drafted in the era when the one-bread-winner family was the rule are no longer satisfactory for employers or employees. The duplication of traditional benefits for two-working parent families has resulted in increased costs to employers accompanied by diminished impact of corporate fringe benefit objectives for employees. Companies are challenged to revise corporate policies to satisfy the needs of this contemporary workforce by diversifying and expanding benefit programs that address the legitimate needs of their organization and employees. Motivated by the need to attract and retain talented, experienced employees, businesses - small and large - are realizing that good benefits make good business sense. Satisfied employees translate directly to a more stable workforce and one which contributes greatly to enhancing the corporate image in the community, thus increasing the pool of talent from which employers can recruit. Consequently, child care is recognized as a fairly universal, attractive benefit and employer-related child care has evolved as a healthy private sector initiative available and affordable to America's working parents.

Current estimates indicate that in early 1984, approximately 1,000 employers offered some type of child care assistance to employees. However, the degree of interest in employer-related child care has far exceeded actual implementation of the programs. Based on the volume of calls and letters received by NACCM and individual members, attitudes are changing and more companies are considering the child care benefit. In response to these inquiries, NACCM has published an Employer-Related Child Care Services Directory to assist businesses in developing a child care benefit for their employees. This directory lists the NACCM companies who are professionals in the business of developing and managing licensed child care centers throughout the U.S. and are capable of and anxious to work with businesses in developing child care programs appropriate to their needs. By focusing on the companies throughout the country who are prepared to work with businesses on employer-related plans, NACCM highlights the fact that child care as a fringe benefit is an appropriate vehicle to look to and utilize the services available in local communities. There are an estimated 20,000 to 25,000 licensed child care centers whose primary business is the provision of quality, licensed child care. Existing facilities, most of which are designed and built to provide a safe and stimulating environment for young children, are located where young families who provide the basis for America's employment force have chosen to live. These child care professionals know the concerns and needs of the working parents in their area and can facilitate developing child care arrangements based on experience and expertise.

Employer-sponsored child care programs can encompass a broad range of options, reflecting the differing characteristics of businesses, labor force composition and company goals. These programs can range from flexible personnel policies or information programs to financial assistance and direct services. Quality child care is a vital concern for working parents, and because it is an expensive service to deliver, represents a major expenditure for young families. We recognize that the cost is also high for companies to allocate resources targeted for a specific group of employees - working parents. Flexible benefit plans provide the vehicle for employers to address different needs of their workforce - including parent employees. The beauty of child care as a fringe benefit is the fact that an employer can totally control the benefit cost. At the employer's option, allotments for the child care benefit can represent a contribution of the tuition fee charged by the center with allotments as little as 5% of the average weekly fee of $45 in our members' centers to as much as 100% of the tuition fee. As an additional incentive, for a number of the programs operated and managed by NACCM members, the child care company provides a discount for employers. One of our member company's programs provides a flat 5% off tuition fees and asks the employer to offer at least a 5% contribution. Another member offers a discount based on a sliding scale that increases with the number of children enrolled in the employer-related program. Programs such as these translate into a benefit to the employees ranging from $117 to $2,500 in one year, based on average NACCM member companies' fees which, can make a tremendous difference in a family budget for working men and women with child care needs. Opportunities for providing a cost effective, quality child care benefit are limited only by the legal aspects mandated by legislative and regulatory guidelines and lack of understanding by the employer.

Incentives are currently in place to encourage employers to provide child care as a benefit through Dependent Care Assistance Plans. In our view, the incentives are substantial, thoughtful, and appropriate. With the recent IRS and Congressional focus on rules for implementing flexible benefit programs including child care and plans for further investigation of specific aspects, businesses should no longer consider the flexible benefit approach as a risk. For this reason, NACCM welcomed the proposed IRS regulations on "Tax Treatment of Cafeteria Plans." Our members' experience indicated many employers were reluctant to proceed with flexible benefit plans, including child care, due to lack of guidance from IRS. Although we believe some aspects of the regulation can be improved, NACCM considers the proposed rule to be an appropriate foundation. NACCM supports legislative and regulatory initiatives that provide expanded opportunities for employees to have a choice of benefits to satisfy diverse needs without burdening the employer with complicated procedures which may drive interested employers away from flexible benefits. At this point, current law and plans to refine and clearly define acceptable corporate procedures may be sufficient incentives for employers. Many organizations may now prefer to be guided primarily by their unique management agenda and needs of their particular employees rather than further initiatives from the federal government.

Of equal importance to clarification of options for providing child care as a nondiscriminatory employee benefit is the need to educate business to the fact that child care is not unique from traditional benefits such as health care. Businesses do not have to become involved in the business of child care when providing the benefit. As Linda McFarland of Hewitt Associates observed, "I wonder if anyone ever thought that to provide medical care for their employees, they had to run a hospital? If an employer had to do that, there probably wouldn't be as many medical plans as there are today. An analogy can be made with child care." There are existing services today in every community that are prepared to work with the business representatives to custom design child care programs most appropriate for the particular organization. The only substantial difference between child care and traditional benefits is the fact that child care addresses employees' needs more directly than any other benefit. Additionally, there are few benefits whose costs can be managed and controlled by employers as directly as this one.

Child care is not a benefit of the future, its time has come. In order to increase available, affordable child care opportunities to parents who want and need to work, child care as an employee benefit is a viable opportunity for the 80's.

In closing, NACCM welcomes your consideration of our comments and appreciates the opportunity provided by the Committee for us to present the perspective of the private, proprietary child care companies.

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Senator PACKWOOD. Ms. Rogin, let me ask you this. The members of your association provide day care, both onsite and at a variety of private proprietary child care centers scattered about cities?

Ms. ROGIN. Right. Their business is running child care centers—developing and managing child care centers that are owned and operated by their companies. They, however, engage in virtually every kind of innovative arrangement with employers that has been documented: Contractural kinds of commitments regarding numbers of children, voucher programs, onsite programs, and even information and referral programs.

Senator PACKWOOD. If you know, I am curious about which a parent prefers, assuming that they have a choice. Let's assume just for the sake of this question that day care costs $100 a child, and the employer says, "OK, you can leave your child at—" one of your clients, B'nai B'rith, or the YMCA—"and I will pay $75 a month. Or, you can bring it to the factory and I'll pay $75 and take $25 out of your salary." Which would a person prefer? Leaving a child in a neighborhood day care center close to where they live, or bringing it into work?

Ms. ROGIN. From all of the research out there, our own companies as well as research done by others, indicates that parents prefer child care arrangements that are near their homes. They select their homes, the places where they live, on the basis of the kind of environment they want to provide for their children, and that same concern applies to where their children spend the day in a safe, healthy environment. They prefer it near home.

Senator PACKWOOD. Dave.

Senator DURENBERGER. Bob, I want to just quickly restate something that a witness said in the last statement about what IRS has done to us. This one company—I think it was First Bank System—said after the IRS and you lost your fight over there they had to go back to their employees again, and they had 2,800 people going into the choice program and only 800 going in after that. The appropriate part of the statement I would like to have restated at this point in the record, demonstrating what Treasury and the IRS have done this year to drive up not only the tax loss but the cost of health care.

Ms. Kopp, in your statement, near the end you say that—

> We believe that placing an overall cap on the dependent care benefit and the dependent care tax credit, together, would provide some guarantee that this will not be a runaway tax expenditure and revenue loss.

Ms. KOPP. That's right.

Senator DURENBERGER. I happen to agree with that 100 percent. Could you just explain for the rest of us why you think that is both good for dependent care and good tax policy, if you will?

Ms. KOPP. Well, the Child Welfare League comes from the point of view that we are serving all children. As a matter of policy, the Child Welfare League is concerned that there be child care assistance for all children who need it. We want to be able to come back to the Senate Finance Committe on another day to talk about the title XX ceiling and day care for children whose families do not benefit from the tax credit or flexible benefit programs—those trying to work their way off welfare as well as many other low income families.

Senator DURENBERGER. It also makes sense, and Bob is the leader of these battles on the floor, that there is always the urgency to income-limit the credit. I don't know where we had to end up, at $40,000 or something like that, last time. And rather than get a good graduating scale that goes all the way up, there is always this other urgency to say, "Well, for the lower income it's OK, but everybody else can afford to do it." And it strikes me that your position here is a better, more thoughtful approach to handling that problem, and it accomplishes the same end.

Now, Ms. Rogin, I don't know if you were here earlier when I talked about the AMA and the doctors, and so forth, but in one way your industry or your profession might be considered where the doctors were 20 years ago. They sort of encouraged us to try to do all these good things for people in an employer/employee relationship, and in those days people were buying their own health care, as Bob pointed out earlier, and it was relatively different from one part of the country to the other or one demographic to another. But the reality is, the whole thing got out of hand. I mean, we didn't put any kind of limits on it. And now there is now stopping, in effect, the proliferation. The physician prices have multiplied seven times since 1965. Hospital prices have gone 10 times over since 1965.

Now, what is to say that isn't going to happen in the dependent care field? I mean, if we just sort of open this wide open, so to speak, it ought to be good for your business; every 4 or 5 years you ought to be able to double your prices and expand your services, and have them popping up all over the place. What is to say that isn't going to happen?

Ms. ROGIN. I would have to say that looking at my members' bottom-line interests, that sounds wonderful. However, I think that is why we are saying to you let's look at the innovative ways to deliver the benefits. Child care is a very slim profit-margin business in the first case, which I think is why when we are talking about discounted services for employers, for instance, there is a limit to what any kind of child care business—for profit or nonprofit—can provide that way.

On the other side, we know that employees value benefits that they have some choice and perhaps some participation in. This is why we say let's look at some options where there is perhaps provider participation in the form of a discount, employer participation in terms of some kind of percentage or dollar amount of contribution per employee, and the balance being employee tuition fees, if you will.

Senator DURENBERGER. Well, what we really need is an innovative way to finance it, not to deliver it; because the reason prices aren't going up is that the demand isn't there, and the demand isn't there not because there isn't a whole lot of need but the demand isn't there because the financial capability isn't there. And now some people are expressing a concern that we might make that financial capability much too easy, so the demand will go up very fast and the supply will get carried away, and the prices, too.

Ms. ROGIN. I think the demand is there. We have seen companies in this industry growing at 20 to 30 percent a year, driven by the demographics of the families that they serve. I think the demand for the service is there. The ability to tie it through employee benefits programs to the work that essentially it serves—for our members we are looking at a work-related service—is perhaps the area of focus.

Senator DURENBERGER. Thank you.

Senator PACKWOOD. Chuck.

Senator GRASSLEY. Mr. Chairman, I have no questions of this panel.

Senator PACKWOOD. Thank you very much.

Ms. ROGIN. Thank you.

Senator PACKWOOD. Now we will have a panel of Cliff Jernigan, Clyde Hanks, and John Bilich.

Mr. Jernigan, why don't you go right ahead.

STATEMENT BY CLIFF JERNIGAN, DIRECTOR, GOVERNMENT RELATIONS, ADVANCED MICRO DEVICES, SUNNYVALE, CA

Mr. JERNIGAN. Mr. Chairman, committee members, my name is Cliff Jernigan. I am director of government affairs for Advanced Micro Devices. We are part of the semiconductor industry in Silicon Valley in California. Our company is the fifth largest maker of semiconductor products in the United States and ninth in the world. We are in the top 15 companies in the book "One Hundred Best Companies to Work for in America."

I think our story is very special and unique. Our fringe benefit philosophy has been very successful and embodies a partnership between the company, employee, and the Government. It involves broad employee stock ownership through the use of stock options and other stock plans. It involves contributions to these plans by our employees, thereby requiring them to share in the risk of the success or failure of our company.

The Government also contributes through the use of tax deferral. We appreciate that, and we would like to see that continue.

This employee cost participation through the investment in our stock has permitted us to continue to purchase needed capital equipment and to make further investments in research and development. For example, last year our research and development as a percent of sales was about 17 percent. This plan has also helped in reducing employee turnover, because employees have a real stake in the success of the company, and it has created greater loyalty.

We would like to see many of the present employee benefit laws continue, because they have been very good for our employees and also very good for the success of our company.

We would like to see some minor reform in the tax law to accomplish what we would regard as greater employee involvement. First of all, we would like to see more employee health cost containment, and in this regard, as you know, when employers provide health insurance and pay the premiums, the premiums are not taxable income to the employee. Perhaps as a way to have more employee involvement in this process and more concern for cost containment, some of these premiums might be taxable to the employee.

Again, in regard to employee involvement, we would like to see plans that further encourage this involvement. For example, we do not think the Paysop law encourages employee involvement; it's more of just an extra nicety to the employee but doesn't tie the employee to the company. We would favor repeal of the Paysop law, but in its place we favor tax laws to permit stock investments on a pretax basis.

Finally, we would like to see a liberalization of the hardship area. Presently the way moneys are withdrawn from our plans is for major emergencies such as major medical expenses or maybe to purchase a home or for a college education. We think these are all worthwhile withdrawal goals, but we think these restrictions possibly discriminate in favor of our higher-paid employees. Many of our lower-paid employees cannot afford a college education or afford the purchase of a home. Therefore, we would like to see some further broadening of the hardship withdrawal areas to permit such withdrawals for maybe emergency car repairs so they can get to work, or other personal and family hardships.

Thank you very much.

Senator PACKWOOD. Thank you.

Mr. Hanks.

[Mr. Jernigan's written testimony follows:]

Finance Subcommittee Hearings
on Taxation of Fringe Benefits
July 26, 27 and 30, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Office Building
Washington, D.C. 20510

Gentlemen:

My name is Cliff Jernigan. I am Director of Government Affairs at Advanced Micro Devices (AMD) of Sunnyvale, California. We are part of the electronics industry in Silicon Valley. AMD is the ninth largest maker of integrated circuits in the world and the fifth largest in the United States. We employ about 6000 people in the United States. We are in the top 15 companies listed in the book The 100 Best Companies to Work for in America.

I will restrict my testimony to those benefit's issues which we consider unique to our industry. With regard to fringe benefits relating to retirement provisions, AMD has a very successful story to tell. As is typical with companies in the electronics industry, AMD has a retirement funding philosophy embodying a partnership between the company, the employee, and the government. In it, the employee accepts part of the responsibility for determining his or her financial future. Our approach in this area encompasses three concepts:

(1) Employer capital formation

(2) Employee capital formation

(3) Employee equity ownership

Before touching on this company-employee-government partnership, I want to describe how I will allocate my testimony time. First, I will describe this partnership. Next, I will list AMD's plans and the breadth of coverage of these plans. Finally, I will give you AMD's thoughts about future fringe benefits legislation.

The partnership for retirement-related vehicles is as follows:

(1) The company contributes:
   - (a) funds to a profit-sharing plan
   - (b) matching contributions to an employee salary reduction plan
   - (c) discounts on the acquisition of AMD stock

(2) The employee contributes by investing his or her salary in AMD stock and in a long-term savings plan

(3) The government contributes through:
   - (a) permitting tax deferment on employee savings
   - (b) allowing tax deductions for company contributions

We believe the employee participation leads to greater loyalty and identification with the company's goals and strategies. It helps to cement a team attitude which is vital to continued success in the international marketplace.

One critical element of our fringe benefit philosophy is that it should help AMD with its own capital formation. In this regard, some of AMD's plans require the purchase of AMD stock, thus providing AMD needed funds for future capital expansion and research and development. This stock ownership is an important part of AMD's total compensation package and has permitted AMD to keep base salaries at a reasonable level and avoid salary inflation in an industry which is extremely competitive with a shortage of key personnel. Moreover, we have maintained our international competitiveness by keeping wage costs closer in line with our foreign competitors, thus helping keep our end selling prices competitive and making our industry one of the country's leading exporters.

The next part of our program is employee capital formation. We have accomplished this goal by asking our employees to assume some of the costs of their retirement benefits, as in the area of stock purchases and our salary reduction plan. In so doing, they have a stake in the success or failure of AMD.

AMD has been very successful and the employees who have made contributions to our plans have been well-rewarded.

The last part of our program is the encouragement of equity ownership in the company. Our employees own about 5% of AMD. Since our stock has had one of the best appreciation records on Wall Street, the value of this equity ownership has increased dramatically for many of our employees. It should also be pointed out that such equity participation has contributed to producing a lower employee turnover rate than for companies not having these kinds of programs, thereby assuring more efficiency of operations from the continuity resulting.

Having stated AMD's employer-employee-government partnership philosophy, I want to address the types of fringe benefit programs we have which embody this philosophy.

First of all, in almost every case, our programs apply to all employees. We have a cash profit-sharing plan plus incentive cash bonus plans based on sales and profits. We also have Section 401 and 401(k) defined contribution plans which in in some cases require employee contributions, a Section 423 employee stock purchase plan whereby the employee can purchase AMD stock at a 15% discount, nonqualified stock options and incentive stock options, a TRASOP and a PAYSOP. All of these plans are designed to permit employees to share in AMD's success. In addition, we have the typical fringes which provide medical and dental care, life insurance, and tuition reimbursement. Given the industry's competitive environment for employee talent, the above plans have been critical in attracting and retaining employees at AMD.

Finally, I would like to address what AMD believes should be the future direction of legislation in this area.

Consistent with our philosophy of the employer-employee-government partnership, we believe that some fringe benefit programs should require employee cost participation. We think especially of health care where a limitation on tax-free status of premiums might help slow down the runaway cost inflation in our society's health care. It will then have all parties involved in the process who have an economic interest in cost-effective, high quality health care.

Next, we believe that fringe benefits legislation should encourage employee participation in equity ownership. In this context, we would support repealing the PAYSOP law, which does not require employee cost participation, in favor of legislation which permits pre-tax dollars to be used to purchase stock in Section 423 plans and other types of stock plans.

Finally, we would like to see a liberalization of the hardship withdrawal area. Presently the regulations in this area permit discrimination in favor of the higher-paid employees. Typical hardship provisions permit plan withdrawals to help purchase a house or provide for a college education. Unfortunately, however, many of the lower-paid employees cannot afford the high cost of housing or a college education. They would benefit immensely by liberalized hardship withdrawal provisions which would permit withdrawal for such items as emergency car repairs and other personal and family hardships which currently have only questionable status.

Thank you for letting me express some of the fringe benefit philosophy of AMD. I hope you will consider our input as you review the employee benefit plan area.

STATEMENT BY CLYDE A. HANKS, MANAGER, HEALTH AND WELFARE PLANS, PEPSICO, INC., PURCHASE, NY

Mr. HANKS. Good morning. My name is Clyde Hanks. I am manager for health and welfare plans for Pepsico. Pepsico is an $8 billion company which employs over 90,000 men and women in the United States. My purpose in speaking today is to provide the committee with an example of actual benefits practice in a major U.S. employer.

Mr. Chairman, I am encouraged by your knowledge of our experience, and I especially appreciate your understanding of the credibility gap that exists between Pepsico's actual experience and Mr. Chapoton's untested theoretical computer models.

As an employer, our challenge is to provide——

Senator PACKWOOD. Let me interrupt for just a minute. You have to understand that when Treasury makes revenue projections they make them on what they call a "static basis." They assume no change in behavior based upon the Tax Code. "If we double the tax on capital gains, we'll double the revenue; if we quadruple it, we'll quadruple the revenue." Surely the theory is not true, but in their defense I've got to say if they start trying to figure out human behavior, then you are into the whole range of subjective judgments about what will the Tax Code induce. Indeed their statis revenue is absolutely fallacious, but if you are going to substitute something for it, then you have got to say what is going to be the subjective substitution.

Mr. HANKS. Perhaps using examples from real life such as Pepsico's may help guide them in their projections.

As an employer, our challenge is really to provide fringe benefits at an affordable cost in a way that meets basic employee needs and in a way that makes us desirable as an employer.

I think Pepsico has done an effective job of meeting these challenges, and we have done it by sticking to three principles:

First, we assure that employees have a minimum set of benefits that protect them against various risks. Every employee has at least basic levels of medical coverage and life insurance. We believe this basic coverage is essential for each employee's financial security as well as their psychological well-being.

Second, we recognize that there is no such thing as the typical employee anymore. That working male with a wife at home with two children is only one of many typical employees today. Of our work force, upward of 40 percent are single. Of those that are married, almost half have a working spouse, and there is a growing number of single parents—mostly women, but some men—who face the task of working full time and raising a family. Each of these workers is a valued employee, and each has a unique benefit need.

Pepsico meets the differing needs of these employees by offering cafeteria style benefits. The company provides each employee with an amount of money to buy benefits and a menu of various benefits types. An employee simply chooses the coverage he or she needs.

Flexible benefits as permitted under section 125 of the Internal Revenue Code are the only way companies can meet the needs of a diverse work force and constrain costs. If flexibility were not permitted, employers would be forced to provide a high level of basic benefits to meet the needs of a minority of employees. That would mean ~~less~~ dollars available for taxable wages.

The third benefit principle Pepsico follows is incentives. In our partnership with employees we feel that we have to create a situation that is in their interest as well as our own. Our flexible spending account which we started in 1985 is an excellent example of how properly designed incentive programs work to everybody's advantage.

The flexible spending account is perhaps the most potent device that Pepsico or any company has in controlling its health care costs in the coming years. The principles of it are simple, the incentives are clear, and the results undeniable. Yet somehow the IRS has argued successfully before Congress that this program will cost the U.S. Treasury money.

The recent rules imposed by Congress in the tax reform bill of 1984 will force employees back into high-option medical plans. Our experience has shown that this is not the case. I hope that this committee will reevaluate the laws approach to flexible spending accounts and reinstitute this needed health care cost containment weapon.

Thank you for the opportunity.

Senator PACKWOOD. Thank you.

Mr. Bilich.

[Mr. Hanks' written testimony follows:]

PEPSICO INC
PURCHASE N Y 10577

STATEMENT

OF

CLYDE A. HANKS

MANAGER, HEALTH AND WELFARE PLANS

PEPSICO INC.

Before the Taxation and Debt Management Subcommittee

of the

Finance Committee

U.S. Senate

Washington, D.C.

July 27, 1984

Good Morning

My name is Clyde A. Hanks. I am Manager, Health & Welfare Plans for PepsiCo, Inc.

PepsiCo is an 8 billion dollar company which employs over 75,000 men and women in the United States. Our main products are the Pepsi-Cola family of soft drinks, Frito-Lay snack foods, Pizza Hut and Taco Bell restaurants and Wilson sporting goods.

Corporation-wide, our single largest expense item in producing our products is compensation for our diverse work force. Our total compensation bill is $2 billion a year or 25% of sales.

Of that, $1.6 billion is direct pay and $.4 billion is in various forms of indirect compensation which is really the area to which I will direct my remarks this morning.

At its root, compensation has three related functions: to attract, retain and motivate the men and women who make and sell our products. The compensation we offer must meet the basic needs of our employees and provide a competitive advantage in attracting the talent we require. At the same time, the cost of compensation must be constrained to assure that our products are competitively priced in the market place and that PepsiCo earns a reasonable rate of return for our shareholders. Balancing these oft-time competing forces is complex.

Indirect compensation is perhaps the most difficult part of our puzzle. One part is the Social Security payments and pensions which combine to provide a basic income to employees when their careers are through. The other part is the health, welfare and other benefits that meet employee needs during their career.

How can we provide these benefits

- at an affordable cost?
- in a way that meets basic employee needs?
- in a way that makes us desirable an employer?

Mr. Chairman, I think PepsiCo has done a pretty good job of meeting these challenges. We have done it by sticking to four basic principles.

First, we assure that employees have a minimum set of benefits that protect them against various risks. Every employee has at least basic levels of medical coverage and life insurance. PepsiCo believes this basic coverage is eesential for each employee's financial security as well as their psychological well-being.

Second, we recognize that there is no such thing as the typical employee anymore - that working male with a wife at home with two children is only one of many "typical" employees today. Of our workforce, upwards of 40% is single. Of those that are married, almost half have a working spouse. There's also a growing group of single parents - mostly women, but some men - who face the Herculean task of working full time and raisng a family. Each of these workers is a valued employee and each has unique benefit needs.

To make this clearer, I will use three hypothetical examples:

Lisa Cruz is married and is covered by health insurance under her husband's plan. She needs life insurance for herself and day care for her 2 year old girl while both she and her husband are at work.

Jim Williams is 20 years old and single. Since he is quite healthy, he needs a minimum of health insurance and not much else.

Vince D'Angelo has a wife at home with three children ages 4 to 10 and one more on the way. He needs everything: medical for the new baby, dental for braces for his 10 year old, life and disability insurance to protect them all if he should die or be crippled.

PepsiCo meets the differing needs of these employees by offering cafeteria-style benefits. The company provides each employee with an amount of money to buy benefits and a menu of various types of benefits. For 1984, this menu offers:

3 medical plans

2 dental plans

vision/hearing coverage

units of life insurance up
to several hundred thousand dollars

units of accident insurance

and long term disability insurance.

An employee chooses what coverage he or she needs.

If it's Jim Williams, he buys the basic medical plan and he still has $436 left from the company contribution. Of this he puts $200 into his Health Care Flexible Spending Account to cover part of his $300 deductible, and he takes the remaining $236 as additional, taxable salary.

If it's Lisa Cruz, she opts-out of medical coverage all together, buys an extra $100,000 in life insurance and puts the $615 remaining from the company contribution into her flexible spending account for day care along with $1,500 of salary to pay her day care expenses.

Vince D'Angelo uses all the company contributions plus $1,360 of his pay to buy the highest coverage medical and dental plans, $100,000 in life insurance, $200,000 in accident coverage and the top LTD plan.

PepsiCo's flexible benefits program allows us to meet the insurance needs of each of these individuals, and at a reasonable cost. PepsiCo's cafeteria approach provides far more cost effective benefits than traditional programs since excess insurance is not required and employees share in the cost of coverage.

Mr. Chairman, flexible benefits - as permitted under Section 125 of the Internal Revenue Code - is the only way companies can meet the needs of a diverse work force and constrain costs. If flexibility were not permitted, employers would be forced to provide a high level of basic benefits to meet the needs of a minority of employees. That would mean less dollars available for taxable wages.

The third benefits principle PepsiCo follows is incentives. If you want employees to do something that is in the company's interest, you need to set it up so that it is in the employee's interest as well. In the hypothetical examples I mentioned a few minutes ago, I noted that Jim Williams put money in a Health Care Flexible Spending Account and that Lisa Cruz put money in her Dependent Care Flexible Spending Account. Our Flexible Spending Accounts, which we instituted in 1984, are excellent examples of how properly designed incentive programs work to everybody's advantage.

It is very clear from the Rand Study and other research into health care utilization patterns that high level medical programs with a lot of first dollar coverage encourage people to be careless health care consumers. It has been repeatedly shown that when an individual has to pay even a few dollars toward some medical care expense, that person is more likely to consider both the necessity and cost of the service. The Rand Study concluded that if a company provides a medical plan with first dollar coverage, more employees use the plan and each user consumes more resources.

PepsiCo understood the results of these studies when we created our current benefits plan, but to offer only a single low option medical coverage would violate our philosophy of flexible benefits. We provide three medical options: a low, medium and high option. Our belief in the widest number of choices said that if an employee wanted a high option they were free to choose it as long as they were willing to pay the price for it. For the first three years of our program, 65 to 70 percent of our employees chose the high option medical plan. These employees were willing to pay out of their own pocket to get the richest health care coverage available. Yet our studies showed that most employees, over 90 percent, would be better off in the leanest medical plan. Our challenge was how to convince our employees to voluntarily choose the lowest medical plan, a plan that would encourage them to be more prudent health care consumers.

We accomplished this by instituting a medical care flexible spending account. We counselled employees to select the lowest medical option that met their needs and to put some or all of the money they saved in premium into the flexible spending account. In this way, they were essentially self-insuring the increased deductible and co-insurance they accepted in the lowest medical plan. We then told them that if they didn't spend the money on the deductible or co-insurance during the year, they could have the money left at the end of the year as taxable compensation.

The program design was simple and the results spectacular.

Fifty percent of our employees voluntarily moved from the high option plan to the low option plan. This reduced the total medical premiums paid by employees by almost 20 percent. Even if you consider the money deposited in flexible spending accounts as a kind of premium, total dollars spent on medical coverage in 1984 - premium plus money in flexible spending accounts - will be less than that in 1983 by an average of $125 per participant. That means an additional $125 is available as taxable compensation rather than being used as a non-taxable medical premium. In addition, it is reasonable to expect that 20 to 30 percent of the dollars deposited in the flexible spending account will not be spent and will also return as taxable compensation.

Mr. Chairman, the flexible spending account, as I have just described it, is perhaps the most potent device that PepsiCo or any company has in controlling its health care cost in the coming years. The principles are simple. The incentives are clear. And the results undeniable. Yet somehow the IRS has argued successfully before Congress that this program will cost the U.S. Treasury money.

The recent rules imposed by Congress in the Tax Reform Bill of 1984 (HR.4170) will force employees back to high option medical plans. Our experience has shown, and I'm confident that it will be verified by many other employers, that flexible spending accounts, with the ability to cash out at year end, can be an important means of controlling escalating health care costs and at the same time increase revenues for the Federal government. I hope that this committee will reevaluate the law's approach to flexible spending accounts and reinstitute this needed health care cost containment.

The fourth principle that PepsiCo applies to the design and delivery of its benefit programs is education. If we want employees to be cost-effective in the selection and use of their benefit program, employers have an obligation to provide information and to educate our employees to their available options. This need is especially crucial given the sophisticated nature of our flexible benefits approach. When employees are knowledgeable about the risks they face and the proper role of insurance in mitigating those risks, they can make better choices under a cafeteria-style benefit program. When employees receive guidance in how to choose and use their insurance plans, they can maximize the benefit they receive without wasting their own, their employers' or the federal government's money.

Mr. Chairman, let me take a moment to describe one program we've instituted to help our employees become better health care consumers. In 1984, PepsiCo commissioned a toll free Healthline that employees can call when they have questions concerning their interactions with the health care system. The Healthline has been an unqualified success. To date, we have had over 250 requests for help in securing second surgical opinions. We also help employees consider alternatives to hospitalization such as out-patient surgery and home health care. We counsel on the potential values of buying generic drugs rather than brand name drugs.

Let me give you two specific examples where the Healthline has not only provided general assistance, but also specific health care support to our employees. Earlier this year, an employee called saying that her physician had recommended open heart surgery for her infant son. The physician suggested that the surgery be done in two or three weeks. The mother was uneasy with the delay because the baby was a very blue color and had difficulty in breathing. Upon discussing the case with the Healthline Coordinator, who is a registered nurse, it was suggested that the woman seek a second opinion that very afternoon. The Healthline Coordinator then researched and found a pediatric cardiologist within reasonable distance from the employee and arranged for an immediate appointment.

That cardiologist recognized the severity of the infant's problem and arranged for open heart surgery the next day. After surgery, the second cardiologist told the employee that if the operation had been postponed two or three more days the infant probably would have died.

In another case, a woman called the Healthline with questions about foot surgery her podiatrist had recommended. The podiatrist had told the woman, an adult in her thirties, that she had recently grown an extra and unneeded bone in her foot that had to be removed surgically. The woman wondered how an adult could grow an extra bone and questioned whether a second opinion might be advisable. The Healthline Coordinator set up a second opinion with an orthopedic surgeon and, as you might guess, that surgeon found no "mystery" bone. The woman's problem was solved through the use of corrective shoes.

These examples show that support services such as PepsiCo's Healthline not only help employees become better users of health benefits, but can also provide a second level of protection against isolated incidents of poor health care.

Mr. Chairman, let me review the four principles that PepsiCo uses to design and provide benefits to its employees. We make sure that their basic needs are covered. We provide flexibility through cafeteria-style benefits to meet the needs of our diverse work force while constraining cost. We build in incentives to encourage employees to become better users of their benefits, and we provide the education and support necessary for employees to make educated choices. PepsiCo is able to provide the valuable benefit program it does in large part because of the tax-exempt status of these benefits. We have accepted our responsibility to provide a basic level of protection to our employees, and we do so in the most comprehensive and flexible way possible given financial constraints. If the tax status of fringe benefits changed and a greater part of the compensation dollar is committed to taxes, less will be available to spend on fringe benefits.

By allowing companies to provide benefits tax free to employees, the government has set up incentives that make it in the best interest of corporations to provide basic welfare needs such as medical care and life insurance. If corporations are unwilling or unable to provide these benefits, the burden will obviously and logically fall back to the government. I think the private sector will be more efficient, more effective, and more responsive in meeting the basic insurance needs of its employees than the government could ever be.

Mexico is a good example of the inadequacies of government provision of benefits. In Mexico, the government has chosen to be the principal supplier of health coverage to its population. Their approach is to tax corporations to fund the health services the government provides. Their health tax represents roughly 8% of salary - 5% paid by the company and 3% by the employee. Yet the care provided is totally inadequate. International corporations such as PepsiCo must provide supplemental health insurance that costs another 2% of salary. In total, health coverage in Mexico costs 10% of salary and is barely adequate at best. In the United States, where we provide very good health coverage, our health costs run about 5% of salary. If we are to preserve the role of corporations in this country providing basic benefit needs to employees, we must retain the freedom they have in designing those benefits and the tax incentive to provide those benefits.

I realize that this year and in coming years, Congress will be wrestling with how to pay for the outlays of the federal government, and I appreciate that there is no simple answer. If Congress should decide in some way to reduce the tax-free basis of fringe benefits - and, as I mentioned above, I don't think this is a wise course - I urge in the strongest terms possible that Congress in no way reduce the flexibility companies have in providing the benefits that they feel are necessary. Every company is different just as every employee is different. If you try to legislate how we should deliver benefits, you will only force companies toward one common middle-of-the-road program. This will renew the inefficiencies of the homogeneous, "typical" employee approach that we have reduced through the use of cafeteria-style benefit plans. If Congress finds that the level of tax free benefits must be reduced, then do so in an overall manner, setting tax free treatment for the first $3,000 of benefits provided by employers to employees. By giving the private sector the freedom to operate under such an umbrella provision, each company will select the optimum way to provide the most benefits to its employees while insuring the financial viability of its benefit program.

Mr. Chairman, thank you very much for the opportunity to address your committee this morning. I look forward to answering any questions you may have.

STATEMENT OF JOHN BILICH, VICE PRESIDENT, HUMAN RESOURCES, ARMCO, INC., MIDDLETOWN, OH

Mr. BILICH. Thank you, Mr. Chairman.

I am John Bilich, with Armco out of Middletown, OH, and after hearing this morning's testimony and not wanting to sound like a broken record, I'm inclined to put my written testimony aside and just offer a few remarks and some key items relative to Armco.

Armco is a multinational company, $5 billion in sales, 35,000 U.S. employees, and over 15,000 overseas employees. Since our founding in 1900 we have been strongly committed to social responsibility, and most especially to the protection of our employees.

Armco has maintained that philosophy for 84 years and feels that our employee benefit programs are an example of our social commitment. Through our employee benefit programs we relieve not only our employees but the government of a substantial economic burden.

We pioneered social insurance programs in 1917, long before the influence of unions, and through the years we have developed perhaps the most comprehensive benefit programs available in industry today.

Somewhat like the Chrysler situation, we have unacceptable levels of about $6,000 a year in employee benefits in the nontaxable area; but, a great deal has been happening in the last few years. We have introduced flexible benefits at many of our locations, and we are seeing dramatic results in shifting of the coverages as the result of these options.

Our programs are designed also to provide similar coverage opportunities from the laborer, to the works manager, and all the way to the president of the company. We simply don't believe in the top hat-type programs for management. About half of our employees are represented by independent or national unions, and as you can well appreciate, the benefit changes require difficult labor negotiations and are never accomplished quickly.

Also, somewhat unique to Armco is the fact that we do provide company-paid lifetime medical coverage to our retirees, also to surviving spouses and dependent children of deceased employees without regard to age.

We are convinced that our commitment over the years has resulted in the most cost-effective coverage possible. I recently had the personal experience to go out and purchase some short-term insurance for my daughter, to bridge her from college graduation to her first assignment as a high school teacher. Needless to say, I was quite disturbed when I had to pay in excess of $100 per month for minimum-level coverage, and I realized that my comprehensive Armco family coverage was only about $190 a month.

We at Armco support the continuation of the existing tax incentives. Without this incentive, we simply would not be able to afford the additional cost. And if that cost or the tax burden were shifted to the employees, we feel strongly that we would certainly see these as negotiating issues in future labor negotiations. In the long run, the burden could very easily shift back to the government, which can ill afford the additional cost.

We feel at Armco that we have fulfilled our social responsibility over the years in providing comprehensive, cost-effective employee benefit coverage, and we urge you and your committee to continue expressing your confidence in us by retaining the current tax treatment of employee benefits.

Thank you.

Senator PACKWOOD. Thank you.

[Mr. Bilich's written testimony follows:]

ARMCO INC. TESTIMONY TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT - FRINGE BENEFITS JULY 1984

Armco is a diversified, multi-national company with $5 billion in sales. We have about 35,000 domestic employees located in 47 of our 50 states and another 15,000 employees overseas.

Armco was founded in 1900 and, in the spirit of our founder, George M. Verity, we've been a leader in employer-employee relations. For example, in 1917 we were the first steel company to provide group life insurance to our employees. We were a leader then in providing protection to our employees and that has continued throughout the years. In 1950 we provided our employees with a noncontributory pension plan as well as a hospital and surgical program. Ten years later we added a major medical benefit, followed by a dental plan in 1966. In 1969, we provided a company-paid Long-Term Disability plan for both our salaried and independent hourly employees. Providing a long-term disability plan to hourly employees was unusual then and still is. A vision care plan was added to the health care package in 1975. In addition to these benefit programs for active employees, we provide company-paid healthcare benefits to most of our retirees and their surviving spouses.

In 1983, Armco spent an average of $6,016 per employee for discretionary, tax-favored benefits. In an effort to control part of this nearly $300 million expense to our company in 1983, we modified our health care program on January 1, 1984, for our salaried and certain represented hourly employees. This medical plan has deductibles and co-pays in addition to other cost control features including pre-admission notification, mandatory second surgical opinion, out-patient incentives and wellness programs. We realize that shifting cost to the employee is not the total answer, so that is why we developed these new provisions to encourage reduced utilization.

Armco has always felt a responsibility to provide all of our active employees and retirees with protection in the event of illness or disability and with retirement income. These benefits are broad based with common programs covering our hourly, nonexempt salaried and exempt salaried employees.

In our group insurance program, we include life insurance, health care coverage, including cafeteria plans for our salaried employees, dental, vision, short-term and long-term disability. Most of these benefits are fully paid for by Armco. Let me share with you two specific cases where our benefits have protected employees from financial disaster.

One Armco employee in our Construction Products contracted Amyotrophic Lateral Sclerosis (known as Lou Gerhig's disease) in 1978.

He retired in 1980 under our pension and long-term disability plan. This provided a lifetime income to him and, in the event of his death, to his wife. In addition to this, we provided life, medical and dental coverage to him and his family. He is still alive today even though the only movement he has is in his forehead. He has electrodes attached to his forehead linked with a computer to enable him to communicate with his family. His medical costs have already exceeded $250,000. The protection provided by Armco covered these expenses and saved him from financial ruin. Most of the expenses were not covered by Medicare, so it was only through private industry that he had protection. Incidentally, Larry has prepared a brochure on his illness which I have attached to copies of my testimony. I think you will find it interesting.

We have another case in Texas involving a female employee with multiple sclerosis. We have paid medical bills of $250,000. Once again, Medicare did not provide coverage for the incurred expenses whereas private industry did. If the U.S. Congress decides that all benefits are taxable, and we in private industry determine we cannot continue to provide such benefits without the tax breaks, the burden will fall on federal and state government. We need only to look at Medicare to see what kind of financial burden that would put on the taxpayers.

I could give you many more examples of what we are doing to protect our employees against such expenses, but I hope I've made the point.

I think it is also important to understand what Armco does for surviving spouses. Once an employee attains 15 years of service, Armco provides that employee with protection for the spouse in the event of the employee's death. If the employee should die, we provide the surviving spouse with a monthly income for the rest of his/her life. We also provide life insurance proceeds and medical coverage for the spouse and his or her dependents. We do this at no cost to the employee or surviving spouse.

We are currently providing benefits to 2,500 surviving spouses, 40% of those are to persons under age 60, which means they are not eligible for Social Security or Medicare. In many of these cases, Armco's payment is the only income the person receives. Combining this with our medical protection means we have relieved the surviving spouse of major worry. If we don't provide this protection because we can't afford it without tax incentives, who will? The federal government? The state government? Once again, I look at the track record of Social Security and Medicare at the federal level and welfare and medicaid at the state level and I shudder at the added tax burden to the individual and to the business community if government tries to pick up this added burden.

I hope the examples I have given you today illustrate the important role Armco's benefit programs play in the social welfare of our employees and the country. Armco isn't alone. Private industry plays a very significant role in this area.

In concluding my remarks today, I would like to answer two questions. Why does Armco provide these benefits? Why am I here today?

First Armco provides these benefits because we feel we have a responsibility to our employees. As I stated at the beginning of my comments, Armco started providing employee protection way back in 1917--long before it was fashionable and long before employee unions started demanding such protection through negotiations. We did it because we thought it was our social responsibility. Armco has maintained that philosophy for 84 years and continues to believe that today. We think we are fulfilling a social responsibility to our employees and to society. Through our benefit programs, we relieve the government of substantial economic burdens. Our fringe benefit plans help relieve the pressure on government-supported social programs.

But our benefits are very costly. If you consider our total benefits costs of over $11,000 per employee per year, almost $600 million with more than $300 million in discretionary tax-favored benefits, it is obvious how prohibitive the costs become if we lose the tax incentives.

That gets me to my second question as to why I am here today. I am here to tell you the Armco story and to ask your help. If we can get the members of Congress to understand the important role business plays in providing these benefits, perhaps the appreciation of our role will increase and in turn the tax incentives for providing these benefits will be maintained. I think I am speaking for many in the business community when I say that without tax incentives, we will no longer be able to continue to provide the benefits we do today. If that happens, the burden will undoubtedly fall on government. We strongly believe the most comprehensive and most cost effective coverages can be best managed within employer provided plans.

Senator PACKWOOD. I want to read about two-thirds of a page of Mr. Hanks' testimony because it proves what many of us have been saying.

Pepsico also operates in Mexico, so they have had some experience with health coverage here and health coverage in Mexico.

I am quoting now:

> If corporations are unwilling or unable to provide these benefits—

He is referring to health benefits—

> the burden will obviously and logically fall back to the government. I think the private sector will be more efficient, more effective, and more responsive in meeting the basic insurance needs of its employees than the government could ever be. Mexico is a good example of the inadequacies of government provision of benefits. In Mexico, the government has chosen to be the principal supplier of health coverage to its population. Their approach is to tax corporations to fund the health services the government provides. Their health tax represents roughly 8 percent of salary—5 percent paid by the company and 3 percent by the employee—yet the care provided is totally inadequate. International corporations such as Pepsico must provide supplemental health insurance that costs another 2 percent of salary. In total, therefore, health coverage in Mexico costs 10 percent of salary and is barely adequate, at best. In the United States, where we provide very good health coverage, our health costs run about 5 percent of salary. If we are to preserve the role of corporations in this country providing basic benefit needs to employees, we must retain the freedom they have in designing those benefits and the tax incentive to provide those benefits.

Mr. Hanks, let me ask you just one question. Is Donald Kendall still a high-up executive of Pepsico?

Mr. HANKS. He certainly is.

Senator PACKWOOD. Do you think you can get him to call Donald Regan and President Reagan on this issue?

Mr. HANKS. Well, I think that your knowledge of Pepsico's situation and conversations that you and other Members of Congress had with Mr. Friedersdorf—who incidentally reports directly to Mr. Kendall—show that Mr. Kendall is aware of the issues, and you would not see our kind of involvement in this issue if he did not support us actively.

I will be very happy to convey your concern back to him. Since I don't mean to speak for him, I will just say that I will pass the message on.

Senator PACKWOOD. Just tell him from this standpoint: from the cost-effective standpoint. I don't know how much you make——

Mr. HANKS. Not as much as Mr. Kendall. [Laughter.]

Senator PACKWOOD. No, I don't think your employee benefits have gone that far in the corporation yet. [Laughter.]

But whatever you make and Mr. Friedersdorf makes, and 10,000 other lobbyists who come to the hearings we are going to have, the costs involved could be obviated if President Reagan were simply to say, "We're done with this nonsense about taxing the employee benefits." It has a good cost-benefit ratio from the standpoint of everyone involved, that is the key.

Much as I appreciate everyone coming here, and much as the great record we are laying, all I need is one word from the President—"No" we won't tax them—and that will take care of it. I have no other statements.

Senator DURENBERGER. Well, before you make that call. [Laughter.]

Let me talk to Kendall. I am not real clear from your statement exactly what his message is going to be, and I think you know where I am coming from: I agree with a lot that I have heard from all three of you, and I compliment you for it.

Using the Mexico example and then putting Japan at the other end of it—and obviously oversimplifying this whole thing—you can look at what I call the Bob Packwood alternative to Bob Packwood, which is the Mexican example, where you just tax the employer, and the Government spends the money. We all know what that gives us—an inadequate health care system and something that is so costly that it makes it more inadequate all the time.

On the other hand, at least the theoretical Japanese model, is that the employer just provides the service almost directly in many cases. I think we have all been through their health clinics and a variety of those sorts of things.

Then in between is the United States, trying to struggle with a better way to do it than either one of those.

It strikes me that in the old days we couldn't have had the three of you come in with the kind of testimony you have today. Five years when I got here, no way would you have been talking to us, Mr. Jernigan, about this variety of choice, and getting the employees involved, and everybody talking about three different medical plans, and all this sort of thing. We wouldn't have had these kinds of conversations 5 years ago because we were on the way to the worst of the Mexican and the Japanese models; the employers were providing one standard of very expensive health care to everybody in this country, and the Government was about to come in and freeze that, make it a Government system, by saying all the hospitals will be paid the same, and "we will increase them 10 percent a year" or something like that—hospital cost containment. And then the Government would come along and put the some kinds of caps on the doctors. That was just the point we almost hit when I got to this committee, I think. Then I think, partially through the defeat of hospital cost containment and the evolution of some choice in this system, we are now able to say—and I think you would admit—that employers are looking differently today at their role than they were 5 years ago, and it's because of these high costs that we are driven to think this way.

Mr. Bilich, you talked about continuity, and I think I need to ask you all about continuity, because we dealt here in the past 1½ year with health care for the unemployed. And we resisted creating a great big new welfare program, like the House did.

But one of the areas that we feel strongly about, I guess is the kind of thing that Armco is already doing—that is, this sort of lifetime situation.

I am glad you brought your daughter into this, because that is the reality of what you all or we all have done to ourselves—we have priced your daughter out of the market. When she gets to be 18, or whatever it is, and she falls out of the comprehensive, we have raised the price to her beyond her reach unless she has got a fairly well-paid daddy or mama.

We have done the same thing in a divorce or a dissolution of the marriage situation; we have done the same thing in a death situation; we have done the same thing in the termination of employment situation. We have created a whole flock of people out there who can't get at the health care system because of its high cost.

Now, one of the solutions is to say, in exchange for all this taxfree benefit, we would like to see some continuity of coverage, the Armco kind of thing, where while you are working, the working people in effect are paying for some period of time—6 months or 1 year, whatever it is, or some other arrangement—for people I have just described who fall through the cracks.

Have the three of you given some thought to that? And do you know what your feelings would be about the cost to employers if we asked for some continuity of coverage?

Mr. Bilich. It is part of our design, I think, as we have looked at our employees or the effect of employees as a result of any changes in status. We typically have probably been too compassionate in terms of the costs. The cost are unfortunately much too great for us to absorb now; but our treatment toward the retirement situation where we do provide continued coverage to retirees, certainly protecting them in the event of the obligations well beyond medicare, is substantial.

Another key factor is areas such as surviving spouses. It is oftentimes overlooked. Probably one of the most dramatic experiences you can have is to walk into a 45-year-old spouse, the husband is just deceased, sitting there with three or four children, and have the ability to tell that surviving spouse, "You don't have to worry about medical coverage; you are covered for life, or until you remarry. The children are protected as long as they are dependent."

I think it is areas like that where, even though the costs are quite high, it brings back the real spirit to the company. We strongly advocate it.

Senator Durenberger. Is there any reaction from you or the other witnesses?

Mr. Jernigan. No further comment.

Mr. Hanks. We at Pepsico follow a similar path to Armco. It is a very, very expensive area, and I think you have to choose hard as to where you want to spend your dollars. We put those dollars for continuity for our valued employees, long-service employees. We provide continuing medical coverage for the retiree and spouse and dependents from retirement through the end of their lives.

For the case where an employee is deceased, we provide coverage to the end of the year following the one in which the employee is deceased.

Senator DURENBERGER. Well, what is expensive about that? Because you have a whole lot of benefits in your plan? Does that raise the cost? I can see where the lifetime benefit may cost something, but to take the surviving spouse, what's terribly expensive about that?

Mr. BILICH. Senator, we are faced currently with 2,500 surviving spouses in Armco's policy, and that cost in our case is lifetime. You are typically talking about medical coverages of several hundred dollars per month.

Senator DURENBERGER. I know, and not a lifetime, but I was back on a continuity, for example, until the end of the year following a death, or something like that.

Mr. HANKS. The cost of health care is high, and that coverage for a spouse with two or three children would run somewhere around $2,000 to $2,500 a year. It is a matter of having *x* amount of dollars, and is that the best place to spend them. That is an area where we choose to spend it, and we bear the cost. But we recognize it, because there is no longer an employee there who is a performing asset bringing money into the corporation. And you really have to manage those kinds of benefits very carefully.

Senator DURENBERGER. But one of your principles—and it is very, very appropriate—is, how can we provide these benefits in a way that makes us desirable as an employer?

Mr. HANKS. Absolutely.

Senator DURENBERGER. And if that in particular makes you a desirable employer, that if one of these unforeseen things happen you can walk into the widow, and so forth, and that makes you a better employer—but you can finance that in other ways. You can finance that by not running up your $200 a month or $225 a month contribution, but let all of you working employees share in that premium cost by a little bit more in a deductible or a little bit more in copayments. The everyone when they are working shares in that cost for the unfortunate few. Would you not agree with that as a theory?

Mr. HANKS. Well, the general function of insurance is the pooled risk, and everybody paying premiums is paying a little bit in the event that that catastrophe happens to them. So it is shared currently.

I think the issue, especially under flexible benefits for our employees, is that they have a certain amount of money from the company to buy benefits, and they have the freedom of choice to say, "I want to spend this on insurance coverage," or, "I want to take this taxable compensation." And we find with our employees that the direct pay that they get, once their basic insurance needs are met, is a much better motivator of employee performance than fringe benefits are.

Senator DURENBERGER. Mr. Jernigan, one way to get employee cost participation in these programs, of course, is through the employer. And one way to get the employer and the employee to get into cost participation is to limit the tax-free nature of all of these benefits. Do you in general favor that kind of a concept?

Mr. JERNIGAN. That's one approach that I think we should consider.

Senator DURENBERGER. Does anybody else argue with that?

Mr. HANKS. I think from Pepsico's point of view, a key point if there were to be a cap on fringe benefits is to retain flexibility under some sort of umbrella cap. If we can provide $3,000 of tax-free benefits to employees, let us put out a menu of benefits and let each employee take from that menu what they need. And some people will need more than $3,000, and they might pay the tax bite. Someone will need less, and they'll take the rest in taxable compensation. But I think the greatest danger is to say, "Well, you've got $200 here and $400 there and $700 here." Not only is it complex and difficult to administer, but again you are forcing everybody to the middle-of-the road program with its built-in inefficiency.

Mr. BILICH. We share that position, that if there is a need for a cap, obviously if we have the flexibility we will design to manage it.

Senator PACKWOOD. Gentlemen, thank you.

Next we have a panel from Iowa: Tom Walker from Agri Industries in Des Moines; John Taylor, the president of Bankers Life; Ronald Pearson, the president of Hy-Vee Food Stores; Jay Storey, the vice president of the Maytag Co.; Michael Munson, vice president of Meridith Corp.; and Edward Shonsey, the vice president of Pioneer Hi-Bred International.

Senator Grassley.

Senator GRASSLEY. Mr. Chairman, I would like, as you have already done, to emphasize that this panel of witnesses is all from Iowa. They are here, obviously, with expertise in this area, and I want to commend them for their willingness to testify. I also wish to thank the chairman of the subcommittee for allowing them to share their expertise with us.

In my experience, I know these panelists as experts in this area and also as people who are active and willing to demonstrate leadership in this area as well.

Senator PACKWOOD. Chuck, thank you. Mr. Taylor, let me express a double appreciation to you. When I was in Des Moines about 3 weeks ago holding hearings on domestic content, Bankers Life hosted a breakfast for me. I appreciate it.

Why don't you go right ahead, Mr. Walker.

STATEMENT BY THOMAS C. WALKER, DIRECTOR OF PENSION OPERATIONS, AGRI INDUSTRIES RETIREMENT COMMITTEE, DES MOINES, IA

Mr. WALKER. I am here today representing Agri Industries which is actually a cooperative movement. We have some 335 member cooperatives in what you would more commonly think of as the rural grain elevator, which is the part that you see in the landscape.

We have 145 of these elevators participating in a fringe benefit program as individual employers in a multiemployer trust-type situation, with over 3,900 participating employees.

Now, I think it is important for you to recognize the fact that over 80 percent of these 3,900 people are making less than $24,000 a year. Over 90 percent of these people are making less than $30,000 a year, and only 13 of 3,937 are making more than $60,000. So basically that means that anything that negatively impacts our particular fringe benefit plans affects virtually only middle and lower class workers.

Now, in preparation for today, in addition to the written testimony, which is somewhat more lengthy than what I will be saying verbally, I took a rather casual poll of 15 of the managers that I represent. And while that certainly doesn't make it a scientific poll, I think the results of the questions that I asked are indiciative of what in fact might happen if the tax status of the plans that we are currently administering were to be changed.

The first question that I asked them was what did they think their particular boards of directors would do if the monies that were currently being spent by their cooperative on their fringe benefit plans were to lose their tax deductible status. And 8 of the 15 simply stated that fringes would cease to exist, and they did not offer to speculate as to what their employer might do in terms of replacing those benefits. The other seven said that they were confident that their boards would in fact do something to replace those benefits, and as long as wages continued to be deductible would probably increase wages to offset.

With that, then, in mind, I asked them what they would do individually if their employer dropped all fringes and raised their pay accordingly. It was interesting to note that what they would do is easily categorized by age groupings. Six of the managers are over 55, and they would continue their benefits irrespective of the taxability of it. Four were under 40, and they thought they would continue their hospitalization but drop everything else. Five of them were between 44 and 53, and they would only respond by saying, 'Gee I'd sure have to think about that.'

The tax laws favoring fringe benefits were enacted under the premise that extensive coverage of workers and their dependents is desirable social policy. I would suggest that nothing has occurred to change that, and that any legislation passed now or in the future needs to be viewed in terms of the impact that it would have on this generation and future generations and not simply in terms of increasing revenues so that some extra dollars would be available to throw at the national debt

The balance of my testimony is in my written words, and I thank you very kindly.

Senator PACKWOOD. Thank you.

Mr. Taylor.

[Mr. Walker's written testimony follows:]

Statement of Thomas C. Walker, CLU, ChFC in connection with the hearings of the Senate Finance Subcommittee on Taxation and Debt Management on the Subject of Fringe Benefits July 26, 27 and 30, 1984.

Summary of the principal points in the statement of Thomas C. Walker, CLU, ChFC in connection with the hearings of the Senate Finance Subcommittee on Taxation and Debt Management on the subject of Fringe Benefits July 26, 27 and 30, 1984.

1. Statement limited to retirement plans.
2. Retirement plans covered by Mr. Walker's statement cover 3,739 individuals with four (4) plans.
3. Over 80% of participants earn less than $24,000 annually and 98% earn less than $48,000.
4. Comparison charts show AGRI plans replace pre-retirement income at rates favorable with amounts stated as desirable by the President's Commission on Pension Policy, 1980.
5. Restatement of the Treasury Department's estimate of 83% loss of revenue due to pension related tax deferrals accounting for lifetime collections.
6. Personal savings aspects of pension plans compared with IRA savings by income groups.
7. Chart distinguishing between legally required benefits, fully taxable benefits, tax-deferred benefits and tax exempt benefits showing distortion created when lumping "benefits" into a single category and assuming a tax loss on the total.
8. Table of discretionary tax favored employee benefits, by specific tax treatment, showing proportion of wages and salaries so allocated to be much less than popularly believed.
9. Table of Analysis G, Budget of the United States Government, Fiscal Year 1985 - must be weighed against the BENEFITS to society.
10. Comparisons over time of numbers of workers covered - and corresponding impact on total costs.
11. Distribution of benefits by employee income categories (over 75% go to employees earning less than $20,000 annually).
12. Use of 401(k) to control employer pension costs.
13. Conclusion: Current law by-and-large serves society well in that the people most needing the benefits are getting them (75% of pension participants and 80% of health plan participants earn less than $20,000).

My testimony will be restricted to the retirement plans we make available to local co-ops (farmer owned grain elevators and processing plants) for their employees. The total number of people presently eligible for benefits is 3,739, including currently employed (3,007), retirees receiving benefits (463), spouses of deceased participants receiving benefits (60), and terminated employees with vested benefits (209).

In order to meet the needs of employers ranging in size from two (2) employees to over four hundred (400), we maintain four (4) plans for the local co-op board of directors to choose from. Two are defined benefit plans (one that the employee contributes to as well as the employer, and one that is 100% funded by the employer) and two are defined contribution plans (one is a pure profit sharing plan and one is a thrift/savings plan).

A total of 145 local cooperatives have their retirement plans with us as follows:

AGRI. RETIREMENT PROGRAM

APRIL 1, 1984

AGRI PLAN	NUMBER OF PARTICIPATING COOPERATIVES	NUMBER OF PARTICIPATING EMPLOYEES
CONTRIBUTORY RETIREMENT	67	1,436
NONCONTRIBUTORY RETIREMENT	76	2,200
THRIFT/SAVINGS PLAN*	77	1,576
PROFIT SHARING PLAN	1	89
TOTALS	221	5,301

* 76 of the employers in this category have two plans and are also included in the Noncontributory numbers. This means only 14 of the employees in this plan are not duplicated. The Thrift/Savings Plan is optional for most employees and approximately 71% contribute on an after-tax basis.

The employees covered under our plans fall into the following income categories:

Income	Total by Category #	Total by Category %	Cumulative Total #	Cumulative Total %
$ 0- 9,000	70	2.4	70	2.4
9,001-12,000	165	5.5	237	7.9
12,001-17,999	1007	33.5	1244	41.4
18,000-23,499	1191	39.6	2435	81.0
24,000-29,999	313	10.4	2748	91.4
30,000-35,999	129	4.3	2877	95.7
36,000-47,999	71	2.4	2948	98.1
48,000-59,999	42	1.4	2990	99.5
60,000-89,999	13	.4	3003	99.9
90,000+	4	.1	3007	100

As you can see, over 80% of the participants earn less than $24,000 annually and 98% earn less than $48,000. Only 13 employees earn over $60,000 and only four earn above $90,000.

These numbers become very significant when placed side-by-side with the myth that "benefit programs are only good for the wealthy."

The following table shows the amounts required to replace pre-retirement income after retirement for married couples retiring in 1980:

RETIREMENT INCOME EQUIVALENT TO
PRERETIREMENT INCOME FOR
MARRIED COUPLES RETIRING IN 1980

SELECTED INCOME LEVELS

REDUCTION IN EXPENSES AT RETIREMENT

GROSS PRE-RETIREMENT INCOME	PRERETIREMENT TAXES FEDERAL[1]	PRERETIREMENT TAXES STATE & LOCAL[2]	DISPOSABLE INCOME	WORK RELATED EXPENSES[3]	SAVINGS & INVESTMENTS		NET PRE-RETIREMENT INCOME
$ 6,500	$ 549	$ 29	$ 5,922	$ 355	0%	$ 0	$ 5,567
10,000	1,311	133	8,556	513	3	251	7,786
15,000	2,550	310	12,140	728	6	728	10,684
20,000	3,968	520	15,512	931	9	1,396	13,185
30,000	6,986	1,061	21,950	1,317	12	2,634	17,999
50,000	15,202	2,622	32,176	1,931	15	4,826	25,419

(Cont'd)

NET PRE-RETIREMENT INCOME	POST RETIREMENT TAXES[4] FEDERAL INCOME[1]	POST RETIREMENT TAXES[4] STATE & LOCAL[2]	EQUIVALENT RETIREMENT INCOME DOLLARS	EQUIVALENT RETIREMENT INCOME RATIO
$ 5,567	0	0	$ 5,576	.86
7,786	0	0	7,786	.78
10,684	0	0	10,684	.71
13,185	0	0	13,185	.66
17,999	53	10	18,062	.60
25,419	1,651	314	27,384	.55

1. Federal income and social security (OASDHI) taxes.
2. Based on state and local 1978 income tax receipts which were 19% of federal income tax receipts. Does not include property tax.
3. Estimated as 6% of disposable income.
4. Post retirement taxes are on income in excess of social security benefits which are non-taxable. Retirees without social security benefits would need higher replacement ratios.

Source: Preston C. Bassett, consulting Actuary, President's Commission on Pension Policy, 1980.

When combining one of our defined benefit plans with social security, the following results are achieved:

AGRI INDUSTRIES
RETIREMENT PLAN AND SOCIAL SECURITY REPLACEMENT RATIOS
FOR A PARTICIPANT RETIRING AT AGE 65 IN 1982
WITH 25 YEARS OF CREDITED SERVICE

Gross Preretirement Income	Benefit as a Percentage of Gross Preretirement Income: Contributory Plan	Social Security	Total	Noncontributory Plan	Social Security	Total
$10,000	34%	55%	89%	20%	55%	75%
15,000	37%	48%	85%	20%	48%	68%
20,000	38%	40%	78%	22%	40%	62%
30,000	39%	27%	66%	25%	27%	52%
50,000	40%	16%	56%	27%	16%	43%

Contributory Plan benefit formula is 1.1% of average monthly earnings up to $400 plus 1.65% of average monthly earnings in excess of $400, all multiplied by years of credited service.

Noncontributory Plan benefit formula is .8% of average monthly earnings up to $1,250 plus 1.2% of average monthly earnings in excess of $1,250, all multiplied by years of credited service.

The Noncontributory Plan is used in conjunction with our Thrift/Savings Plan by all the employers who installed this particular defined benefit plan. This means the employees have the option of enhancing their retirement income by setting aside up to 6% of their W-2 earnings on an after-tax basis. The employer matches either 25% or 50% (the employer chooses one for all employees) of the amount set aside by each employee who chooses to participate. The numbers above for the Noncontributory Plan do not include any Thrift/Savings enhancement.

What do these numbers really mean? They mean that Congress should be thanked for writing laws that have helped to improve the economic security of every single one of the people served by our plans, and the millions of participants and beneficiaries of plans all over our great nation. This is particularly true since programs such as ours, are truly serving the middle and lower income population. Referring back to the table showing our benefits in concert with Social Security, it is quite obvious that our people would see a reduction in post retirement income of 20 to 40% without one or the other of our plans being in place. This shows very clearly that benefits DO NOT principally go to the highly paid and workers WILL suffer if employer sponsored benefits do not exist.

We also understand the dilemma faced by our elected representatives in Congress who must deal with the out-of-control growth of our national debt. They must look at all possible sources of revenue and would be open to criticism if they did not. Accurate information is essential and also sometimes very difficult to find. One piece of information I have a problem with is the Treasury Department's number on tax losses for pension related tax deferrals. I believe they are overstated. Treasury statistics imply that 83 cents out of every deferred dollar is permanently lost, with the other 17 cents accounted for by current tax payments by retirees. When examined in a lifetime context, the proportion of deferred taxes lost to the Treasury ranges from 14 cents out of every dollar to 40 cents, depending on whether or not one adjusts for inflation and interest on deferred taxes and the interest factor used.

How Much of Pension-Related Tax Deferrals is Lost to the Treasury?

Method Used	Taxes Lost	Taxes Deferred
Treasury Method	83%	0%
Lifetime Method:		
Nominal dollars[a]	14	86
Real Dollars[b]	28	72
Discounted for interest:[c]		
at pension rate	40	60
at federal rate	36	64

SOURCE: Sophie M. Korczk, Retirement Security and Tax Policy (Washington, D. C.: Employee Benefit Research Institute, forthcoming).

[a]Before adjusting for inflation.
[b]After adjusting for inflation.
[c]Interest rate used to discount taxes paid in retirement to the year of retirement.

Pension benefits are not a "today" benefit but rather a long term proposition and the tax aspects can only be fairly viewed when placed in the same time-frame as the benefit itself. The table above certainly suggests that changing the taxability of pension related tax deferrals will not raise the number of dollars that is suggested by the 83% taxes lost number being used by our Treasury Department.

What are the savings aspects of pension coverage for participants? Pension coverage constitutes the major source of savings for more than half of current pension participants. While 52.2 million persons, or 56.4 percent of the labor force, had little or no savings of their own in 1979, 26.8 million, or more than half, were covered by employer pensions. Since these persons had incomes just over half the size of those with some savings, pensions appear to distribute wealth more equally than would be the case in their absence.

TABLE 6

Savings, Pension Coverage, and Income, 1979

Savings Status[a]	Covered[b] (in millions)		Not Covered (in millions)		Average Annual Income	
No savings[c]	26.8	29.0%	25.4	27.4%	$ 7,672	56.4%
Some savings	25.9	28.0%	14.4	15.6%	13,914	43.6%
Total	52.7	57.0%	39.8	43.0%	11,193	100.0%

SOURCE: Employee Benefit Research Institute calculations based on Bureau of the Census, Current Population Survey (May 1979).

[a]Persons are classified as having some savings or no savings according to whether or not they reported any asset income in the survey. Asset income includes interest, dividends, rents, and royalties.

[b]Coverage refers to employer plans only, both in the public and in the private sector, and does not include holders of IRA and Keogh accounts.

[c]Includes persons reporting negative asset income.

These numbers become particularly significant when you compare them with the distribution of earnings and IRA participation. The people most served by pensions are least able or willing to utilize the IRA.

CUMULATIVE EARNINGS DISTRIBUTION:
IRA AND SPOUSAL IRA PARTICIPATION FOR THE CIVILIAN LABOR FORCE
AND THE ERISA WORKFORCE, MAY 1983

EARNINGS	Employment Distribution	IRA Contribution Distribution	Distribution among those Eligible for Spousal IRA: Contributes to IRA	Established Spousal IRA
ERISA Workforce				
Total Employees* (000's)	52,136	11,204	2,189	1,378
less than $5,000	1.86%	1.11%	0.88%	1.30%
less than $10,000	16.21%	8.86%	4.18%	3.09%
less than $15,000	39.46%	23.52%	13.77%	9.39%
less than $20,000	59.54%	41.07%	28.63%	21.99%
less than $25,000	76.48%	57.58%	43.61%	38.34%
less than $30,000	85.89%	70.96%	57.81%	50.31%
less than $50,000	97.13%	91.87%	83.66%	79.05%
Total Earnings	100.00%	100.00%	100.00%	100.00%
Civilian Labor Force				
Labor Force* (000's)	87,067	14,481	2,905	1,630
less than $5,000	13.71%	5.81%	3.91%	3.55%
less than $10,000	32.94%	15.60%	9.81%	6.12%
less than $15,000	54.81%	30.17%	20.19%	12.48%
less than $20,000	70.48%	46.51%	34.27%	25.04%
less than $35,000	82.75%	61.32%	49.05%	41.41%
less than $40,000	89.44%	72.75%	61.41%	52.57%
less than $50,000	97.68%	91.95%	85.00%	79.78%
Total Earnings	100.00%	100.00%	100.00%	100.00%

*Excludes workers without reported earnings

Source: Employee Benefit Research Institute, preliminary tabulations of May 1983 EBRI/HHS CPS pension supplement.

Employee benefits serve a number of purposes. Pensions, profit-sharing plans, and employee thrift plans provide for deferral of income and encourage private saving for retirement. Health benefits, disability income plans, life insurance, and supplemental unemployment benefits provide insurance protection against unanticipated, catastrophic events. Some programs provide for consumption; these include day care benefits and, sometimes, routine dental and vision care benefits. Many of these benefits, together with employee vacation time and rest periods, are intended to raise employee productivity, reduce time lost from work, and build positive employee relations.

Expanded employer pension and welfare plans over the past thirty years have significantly improved the income security of current workers and future retirees. Growth of employer group health insurance coverage among workers and their dependents has promoted wide access to health care throughout the nonelderly population. These achievements are, in part, a response to tax incentives.

The growth of employee benefits as a form of employee compensation has attracted increasing attention in recent years chiefly because of a concern that the growth of benefits occurs at the expense of growth in wage and salary income. Slower growth of wages and salaries, in turn, implies slower growth of the tax base. Erosion of the tax base affects the public sector's ability to finance government programs in general and the Social Security system in particular. In addition, growth of nontaxable benefits may generate an important redistribution of the tax burden across the population. These effects of growth in employee benefits, and in tax-exempt benefits in particular, merit careful attention.

For purposes of analysis, employee benefits can be classified into three categories:

* legally required benefits (including employer contributions to Social Security, unemployment insurance and workers' compensation insurance);

* discretionary benefits that are fully taxable (primarily payment for time not worked); and

* discretionary benefits that are tax-favored (including employer contributions to pension and health insurance plans).

Discretionary employer contributions to tax-favored benefits (those that are not taxed as current income to the employee) can be further subdivided into two groups: benefits on which taxes are deferred and benefits that are tax exempt.

* Tax-deferred benefits primarily include employer contributions to retirement income and capital accumulation plans. Taxation of these benefits is deferred until the employee withdraws funds from the plan.

* Tax-exempt benefits include employer contributions to group health insurance and a variety of smaller benefits that include dental insurance, child care, merchandise discounts, and employer-provided meals.

Discretionary tax-favored employee benefits represent about 28 percent of all employee benefits and 9 percent of wages and salaries. Since 1950, tax-favored employee benefits as a share of compensation (table 8) have grown at an average annual rate of 4.4 percent, compared to somewhat slower growth of legally required benefits and of taxable discretionary benefits.

TABLE 8

Average Annual Growth Rates of Major Employee Benefits as a Share of Total Compensation, 1950-1983

	Average Annual Rate of Growth (in percents)		
Employee Benefit	1950-1980	1970-1980	1980-1983
Total Benefits	2.5	1.8	2.2
Legally Required Benefits	2.6	2.1	3.0
Discretionary Fully Taxable Benefits[a]	1.4	1.2	1.2
Discretionary Tax-Favored Benefits	4.4	3.0	3.0
Government Pensions	2.1	0	0
Private Pensions and Profit-Sharing	4.9	4.5	1.9
Group Health	6.3	4.5	6.1
Group Life	2.3	-2.2	0

SOURCE: EBRI calculations based on U.S. Chamber of Commerce, Employee Benefits 1982 (Washington, D.C.: Chamber of Commerce, 1983).

a/ Vacation time and other time not worked. Calculations based on interpolations from Chamber of Commerce data for 1980 and 1982.

Employer contributions to group health insurance are the fastest growing component of employee benefits. The expansion of worker and dependents' coverage under employer group plans, the enhancement of benefits under these plans, and persistent high inflation in health care costs have all contributed to the growth of employer contributions to health insurance as a share of compensation. Between 1950 and 1980, employer health insurance contributions as a percent of total compensation have risen at an average annual rate of 6.3 percent. Reflecting continued high inflation in health care costs since 1980, employer contributions to health insurance have continued to grow at an average annual rate of 6.1 percent more than the growth of compensation.

Failure to distinguish among the growth of legally required employer payments, fully taxable employee benefits, tax-deferred benefits, and tax-exempt benefits has greatly distorted the perception of the tax-base erosion that can be attributed to tax-favored and tax-exempt benefits. This common misperception was highlighted by Secretary of the Treasury Donald Regan; his May 22, 1983, statement to ABC News included the following comment:

> "I think that when you look at the way our pension systems, our medical systems and the like are. . . running at full throttle, and are increasing year after year, that sooner or later they're going to have to be slowed down or else we'll never get these deficits under control."

The size of tax-favored benefits as a proportion of wages and salaries, however, is much smaller than such statements suggest. Table 9 summarizes the distribution of descretionary tax-favored benefits by tax-deferred and tax-exempt status. In 1982, tax-deferred benefits constituted about 4.5 percent of wages and salaries; tax-exempt benefits constituted 4.6 percent.

TABLE 9

Discretionary Tax-Favored Employee Benefits by Specific Tax Treatment, 1982

Tax Status/ Benefit Group	Employer Contributions as a Percentage of Wages and Salaries	Employer Contributions as a Percentage of All Benefits	Employer Contributions as a Percentage of Tax-Favored Benefits
All Tax-Favored Benefits	9.0	27.7	100.0
Tax-Deferred Benefits:	4.5	13.8	49.5
Pension and Profit-Sharing Plans a/	4.0	12.3	44.0
Short-and Long-Term Disability Insurance b/	0.3	0.9	3.3
Other Tax-Deferred Benefits c/	0.2	0.6	2.2
Tax-Exempt Benefits:	4.6	14.2	50.5
Contributions to group health and life insurance d/	4.1	12.6	45.1
Other tax-exempt benefits e/	0.5	1.5	5.5

SOURCE: EBRI tabulations of U.S. Chamber of Commerce estimates in Employee Benefits 1982 (Washington, D.C.: U.S. Chamber of Commerce, 1983). pp. 11 and 28.

NOTE: Figures may not add to total because of rounding.

a/ Includes EBRI estimate of employer contributions to profit-sharing plans based on Chamber of Commerce figures.
b/ EBRI estimate based on Chamber of Commerce figures.
c/ Includes EBRI estimate of employer contributions to employee thrift plans based on Chamber of Commerce figures.
d/ Estimate includes fully taxable employer payments for life insurance in excess of $50,000.
e/ EBRI estimate of discounts on merchandise, meals furnished by company, payments for vision care and prescription drugs, and moving expenses, based on Chamber of Commerce figures.

Private retirement program tax expenditures form the single largest category of tax expenditures in the federal budget. They arise from the deferral of taxes paid on: (1) pension and retirement saving contributions; and (2) earnings on these contributions. Tax deferral of pension and retirement saving contributions represents deferral of current revenue; taxes are paid on withdrawals from the funds after the worker retires. In a lifetime context, however, gross federal revenue losses are significantly lower than current revenue deferrals. As much as 75 percent of the real (i.e., inflation-adjusted) value of taxes deferred during pension participants' working careers is ultimately repaid in retirement income taxes.

(Sophie Korczyk, Retirement Security and Tax Policy (Wahington, D.C.: Employee Benefit Research Institute, forthcoming). These simulation results are consistent with calculations for hypothetical workers reported by Richard A. Ippolito, "Public Policy Towards Private Pensions" Contemporary Policy Issues, 3 (April 1983): 53-76.)

TABLE 10

Employer Benefit Tax Expenditures in the Administration's Budget by Budget Function, Fiscal Years 1983-1985 (In millions of dollars) a/

Provision	1983	1984	1985
Commerce and Housing Credit:			
Exclusion of interest on life insurance savings	$ 4,335	$ 4,720	$ 5,180
Education, Training, Employment, and Social Services:			
Employer educational assistance	40	20	--

(Cont'd)

Provision	1983	1984	1985
Exclusion of employer provided child care	$ 20	$ 40	$ 70
Exclusion of employee meals and lodging (other than military)	680	725	795
Exclusion of contributions to prepaid legal services plans	40	40	45
Investment credit for ESOPs	1,250	1,375	1,875
Health:			
Exclusion of employer contributions for medical insurance premiums and medical care	15,270	17,625	20,165
Social Security and Medicare:			
Exclusion of Social Security benefits:			
OASI benefits for retired workers	14,035	13,895	12,975
Benefits for dependents and survivors	3,775	3,755	3,765
Disability insurance benefits	1,310	1,225	1,105
Income Security:			
Exclusion of railroad retirement system benefits	780	615	450
Exclusion of workman's compensation benefits	1,885	2,020	2,215
Exclusion of special benefits for disabled coal miners	160	155	155
Exclusion of untaxed unemployment insurance benefits	2,960	2,305	1,800
Exclusion of disability pay	120	75	--
Net exclusion of pension contributions and earnings:			
Employer plans	46,585	50,535	56,340
Individual Retirement Accounts	8,855	9,190	9,840
Keoghs	1,460	1,475	1,530
Exclusion of other employee benefits:			
Premiums on group term life insurance	2,040	2,170	2,380
Premiums on accident and disability insurance	120	120	125
Income of trusts to finance supplementary unemployment benefits	20	20	20

(Cont'd)

Provision	1983	1984	1985
Veterans benefits and services:			
Exclusion of veterans disability compensation	$ 1,815	$ 1,810	$ 1,855
Exclusion of veterans pensions	345	335	340
Total	$107,950	$114,295	$123,125

SOURCE: Special Analysis G. Budget of the United States Government, Fiscal Year 1985.

a/ Budget functions are groups of federal programs or activities that address a common national need. There are 18 budget functions.

Employer contributions to group health insurance are the fourth largest tax expenditure in the 1985 budget. These contributions are exempt from Social Security, corporate income and individual income taxation.

Tax expenditure estimates are a poor guide for setting either federal tax policy or federal retirement or health policy. Nevertheless, the high tax expenditure estimates for pension and group health insurance plans continue to attract public attention and critical appraisal of these plans' tax-favored status. Measurement of current versus lifetime tax revenue losses, however, is only part of the task of evaluating tax preferences for employer pension contributions, retirement saving, and employer-sponsored health insurance. The benefits to society that derive from tax preferences for these plans must also be appraised. Tax laws favoring employer retirement and health insurance plans were enacted under the premise that broad coverage of workers and their dependents under these plans is desirable social policy.

Worker Participation in Tax-Favored Employee Benefits

Between 1950 and 1979, the rate of worker participation in employer pensions grew by 23 percent; in absolute numbers, employee pension participation rose by 263 percent. Econometric estimates suggest that, since 1960, 20 to 30 percent of the increase in employer pension contributions as a share of compensation can be attributed to favorable tax incentives and the growth of real marginal tax rates.

The tax deferral of employer pension contributions and individual retirement saving provides important incentives for employers and workers to provide for retirement income. The increasing importance of pensions as a source of income projected among future retirees is the direct result of past growth in pension plan participation among workers. The projected rate of pension recipiency among today's young workers (ages twenty-five to thirty-four) is nearly twice that of workers who are retiring today (see table 11).

TABLE 11

Estimated Percentages of Families
Receiving Pension Benefits at Age Sixty-Five, and Average
Real Benefits, by Current Age and Marital Status

	All Families		Married Couples		Single Persons	
Cohort Age in 1979	Percentage to Receive Benefit	Average Amount of Benefit a/	Percentage to Receive Benefit	Average Amount of Benefit a/	Percentage to Receive Benefit	Average Amount of Benefit a/
25-34	71	$12,417	75	$14,541	65	$8,701
35-44	65	11,190	67	12,563	60	8,823
45-54	52	8,656	58	9,621	41	6,496
55-64	37	5,315	44	5,548	26	4,718

SOURCE: Social Security: Perspectives on Preserving the System (Washington, D.C.: Employee Benefit Research Institute, 1982), p. 90.

a/ Real dollars are calculated using 1982 as the base year.

Partly because of tax incentives, participation in employer pension and health insurance plans is high. In 1979, 48 percent of the total work force participated in an employer pension plan; 74 percent were covered by an employer group health insurance plan. Among full-time, full-year workers, rates of coverage are much higher. In 1979, more than 74 percent of full-time full-year workers participated in an employer pension plan, and 89 percent were covered by an employer health plan (Schieber and George, Coverage and Benefit Entitlement, pp. 38 and 54; and Chollet, Employer-Provided Health Benefits. Pension coverage rates for full-time full-year workers include only nonagricultural workers, age twenty-five to sixty-four, with one year of service and working more than half-time. Health insurance coverage rates include all full-time nonagricultural workers who worked fifty weeks or more during 1979). Participation in tax-favored individual retirement saving plans is more modest. In 1982, 13 percent of all households that filed a federal income tax return reported participation in an individual retirement account (IRA). (U.S. Department of the Treasury, Internal Revenue Service, "Selected Statistical Series, 1970-1983," Statistics of Income (SOI) Bulletin, 3 (Winter 1983-84): 62).

Employee benefits are widely distributed among workers and their families at all income levels. Reflecting the concentration of workers at low and middle incomes, most workers who participate in employer pension and health insurance plans are low or middle income workers. In 1979, 75 percent of all workers covered by an employer pension plan under ERISA standards, and 80 percent of all workers covered by an employer group health plan, earned less than $20,000 (see table 12).

TABLE 12

Distribution of Employees with Pension and Health Coverage
by Earnings, 1979

Earnings	Employees with Pension Coverage		Employees with Health Coverage	
	Total	Percent	Total	Percent
	(in millions)		(in millions)	
Less than $20,000	27.8	75.3	58.3	79.8
$20,000 to $49,999	8.7	23.7	13.9	19.1
$50,000 and over	0.3	0.9	0.8	1.1
Total a/	36.9	100.0	73.0	100.0

SOURCES: Pension distribution based on Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement (Washington, D.C.: Employee Benefit Research Institute, 1981). Health distribution from EBRI tabulation of the May 1980 Current Population Survey (U.S. Department of Commerce, Bureau of the Census).

a/ Figures may not sum to totals because of rounding.

The growth of new tax-favored employee benefits has alarmed those who see the emergence of these benefits simply as further erosion of the tax base. In fact, employers often have independent motivations for setting up these plans. The growth of new benefits, in particular Section 401(k) salary reduction plans, generally represents an effort by employers to contain the cost of tax-favored employee benefits.

Rising employer pension costs have prompted several innovations in the design of retirement income plans. Section 401(k) plans, authorized by the Revenue Act of 1978, have become an increasingly popular tool for controlling employer pension costs. Employees are able to supplement employer contributions to a Section 401(k) plan with tax-deferred contributions of their own. This allows employers to contain their retirement plan costs. In general, Section 401(k) plans probably represent a net reduction in employer pension contributions relative to the level that would be required to ensure adequate retirement income with lower employee retirement saving.

Section 401(k) plans also reduce the employer's projected cost of indexing retirement benefits. Although pension benefit increases are seldom automatic, most employers provide *ad hoc* cost-of-living adjustments for current retirees. Under current law, sponsors of defined-benefit pension plans cannot reserve funds against future *ad hoc* cost-of-living increases, even in cases where the plan has a clear history of providing those increases. *Ad hoc* increases, therefore, are funded from current contributions, or offset against actuarial gains, or added to the plan's unfunded liability.

Section 401(k) plans--and other defined contribution plans--represent a way to provide employees with some inflation protection in retirement, at a substantially lower cost to employers. Defined contribution plans are automatically indexed, since the asset value of the plan generally rises with inflation. Inflation reserves, therefore, accumulate automatically.

Section 401(k) plans also meet the demand for retirement income security among mobile workers and workers with intermittent labor force participation. Employee contributions to Section 401(k) plans are, by law, fully and immediately vested. Short-tenure workers, therefore, may be better served by 401(k) plans than by more traditional plans. These workers, and workers with intermittent labor force participation, are protected because they can "roll over" the accumulated contributions and earnings of the plan into a tax-deferred individual retirement account. As a result, Section 401(k) plans may particularly benefit young workers with high labor-force mobility and women who may leave the labor force for protracted periods.

Many observers of the emerging changes in employee benefit plans have claimed that the development of new forms of employee benefits merely represents further tax-base erosion. These claims, however, have often been made with little or no supporting evidence. There are several reasons to believe that the growth of nontraditional benefits, in particular Section 401(k) plans, may actually reduce further erosion of the payroll and individual income tax bases.

While employer contributions to traditional pension plans are entirely tax-deferred, employee contributions to Section 401(k) plans are taxable by Social Security. Employers have favored Section 401(k) plans as a means of reducing the level of contributions they might have to make if they offered only a traditional pension plan. If the growth of Section 401(k) plans does, in fact, substitute for the growth of more traditional pension benefits, they would represent an addition to the current payroll tax base.

In conclusion, the tax laws favoring specific employer retirement and health insurance plans were enacted under the premise that extensive coverage of workers and their dependents under these plans is desirable social policy. The growth of worker coverage by pensions and health insurance since 1950, has been strongly encouraged by the tax advantages accorded these plans, and by the growth of real marginal tax rates.

Employee benefits are widely distributed among workers and their families at all income levels. Like the labor force as a whole, most workers participating in employer pension and health insurance plans are low and middle income workers. In 1979, more than 75 percent of all workers covered by an employer pension plan under ERISA standards, and 80 percent of all workers covered by an employer group health plan, earned less than $20,000. Contrary to the perceptions of many, there is no evidence that tax preferences for employee benefits favor only highly paid workers.

The historic growth of private pension plan participation among workers, and the current growth of worker participation in Section 401(k) plans and IRAs represent private saving for retirement income. Considering the increasing cost of Social Security and the projected decline in the ratio of workers to retirees, private saving for adequate income replacement in retirement has emerged as a necessary and desirable public goal.

The emergence of nontraditional benefits warrants careful and balanced scrutiny. These benefits generally serve to balance the interests of employers seeking to contain benefits costs and the interests of employees, who demand a more diversified package of benefits than ever before. The new forms of employee benefits may serve best those workers whose needs are least adequately met by more traditional benefits--younger workers and employed parents. Further, the growth of nontraditional benefits may actually contribute to the payroll and income tax bases, to the extent that the new employee benefit forms substitute for traditional tax-exempt or fully tax-deferred benefits.

A final note: "Tax deductible" does not mean dollar-for-dollar offset. Even in the highest bracket, half of every deductible dollar spent could have been retained by paying the tax on it rather than spending it.

Respectfully submitted,

Thomas C. Walker, CLU, ChFC
Director, Plan Operations
AGRI Industries Retirement Committee
P. O. Box 4887
Des Moines, Iowa 50306

TCW/lhl

STATEMENT BY JOHN TAYLOR, PRESIDENT, THE BANKERS LIFE, DES MOINES, IA

Mr. TAYLOR. Mr. Chairman, Senator Durenberger, Senator Grassley, I certainly appreciate the opportunity to come here to make a few brief comments about the social value of benefit plans.

I am John Taylor. I am president and chief executive officer of the Bankers Life in Des Moines, IA. We are a collection of financial companies which, among other things, serve about 50,000 employer-sponsored benefit programs. These plans cover about 2 million participants. We manage the assets of about $8.5 billion that is devoted to employee benefits, and we pay out over $1.5 billion in employee benefits every year. We have been in the employee benefits business for over 40 years.

I have furnished material, but I would like to make a few brief verbal comments as well, primarily in the area of the importance of the partnership between the Government and the private sector in providing employee benefits but also in terms of some other data which I have furnished. You will find the data in my written material, but let me make a couple of comments about that.

One sample there has to do with the 5,000 employees in the benefit programs of our own company, and the other is a sample of a cross-section of the benefit programs that we manage.

This data shows that 97 percent of plan participants, whether you are looking at either sample, earn less than $50,000 a year, and, depending on the particular sample you look at, two-thirds to three-fourths earn less than $20,000 a year.

Now, our customers are dispersed in every kind of business across the country you can imagine, geographically, employers large and small. And I would suggest that our data represents a good cross-sample of what is going on in the employee benefit business today.

Now, why is this data important to you? We keep hearing that Congress thinks that employee benefit plans are for the very rich, but our experience—which is very broad—with small to medium employers and a sprinkling of large employers, shows that those benefits are overwhelmingly for the rank and file, for low-income and middle-income workers. Sure, there are some high-paid employees there, but they are a tiny minority.

We support strongly this partnership which has developed over the years, and we hope that in your evaluation you will continue to look at the long-range aspects of that and not go for short-range benefits.

I would like to make one other comment, Senator Packwood. You raised a question earlier about group auto and group homeowners' plans. We have written over 500 of those kinds of programs, probably more than any other insurance company in the United States, and we would be very happy to furnish data to you at some time in the future on those programs if you would like that.

Thank you very much.

Senator PACKWOOD. I assume at the moment, though, that at least in theory all the beneficiaries pay taxes on the value of the premium.

Mr. TAYLOR. Yes; they do.

Senator PACKWOOD. Mr. Pearson.
[Mr. John Taylor's written testimony follows:]

Written Testimony of John R. Taylor, President and Chief Executive Officer, Bankers Life, Des Moines, IA

I'm John Taylor, President and Chief Executive Officer of The Bankers Life in Des Moines, Iowa. We are a collection of financial companies which, among other things, serves about 50,000 U.S. employer sponsored pension and welfare plans covering 2 million participants. We manage between $8-9 billion of pension assets for these plans and pay out $1 1/2-2 billion dollars per year in benefit payments. We've been in the employee benefits business over 40 years.

I'm here today to comment on the strength of our nation's partnership between the public and private sectors in providing those so called fringe benefits which are aimed at the major financial hazards for an employee--retirement, disability, catastrophic medical expenses, and employee death where dependents survive. Replacing lost employee income is the primary theme of these programs.

First, a couple of facts about our plan for our own employees. We have over 5,000 employees in our welfare programs (medical, disability and life insurance). Three-fourths of our welfare plan participants earn less than $20,000 per year. And 97% earn less than $50,000 per year. In our pension plan, which covers about 4,000 people (the 1,000 difference is our under 25 year old employees) 2/3 of the participants earn less than $20,000 per year and 96% less than $50,000. (Tables are attached showing detail.)

Next some facts about our customers. For most, we don't have employee wage and salary data in our records. But for 3,700 defined benefit pension plans covering 174,000 workers, we do have wage data in our files and have analyzed it. Sixty-five percent of these participants earn less than $20,000 per year. And over 97% earn less than $50,000 per year. These plans average covering about 50 employees each and many are much smaller.

But are these rank and file workers vested? Yes to a great degree. Almost half these participants have some vesting, and of these vested people, 56% earn under $20,000 per year and 96% earn under $50,000 per year. Again a table is attached.

What about retirees? We're paying pensions to over 100,000 retirees who are averaging less than $2,000 in annual pension.

Why is this data useful to you? We keep hearing the Congress thinks these programs are mostly for the rich, and we want you to know that in our broad experience with the small and medium size employers in the U.S., their programs are overwhelmingly providing benefits for rank and file workers, for low income and middle income workers. Yes the high paid are in there also, but they are a tiny minority.

During this century, the federal government has built the Social Security, Medicare and Medicaid programs, and has maintained tax laws favorable to private sector development of similar programs. We see first hand in our day-to-day business the strength of this public/private partnership in helping the ordinary worker. Depending on how you measure it, we have perhaps 1-2% of the employee benefit plan market in the U.S. Our customers are dispersed throughout the U.S. in every kind of private business imaginable. Our customers are likely a cross sectional slice of much of employee benefits in the U.S.--primarily small and medium size firms, but with a good representation of the very large U.S. companies.

The data given earlier is to show you that all of us together have built a mighty partnership to protect America's workers against major financial hazards. And we ask you to move cautiously in improving it that we avoid tipping the scales to start the employee benefits system on a downward path.

The Census Bureau projects our over age 65 population moving from about 12% of population today to almost 20% some 40 years hence. Even with a significant push-back of retirement age, we're going to need more than ever a strong public/private partnership on both retirement income and medical expenses for our retired workers. Private enterprise has built an effective and efficient supplement to public programs covering employee needs. These needs are there and must be met. The private system should not be dismantled in the name of tax revenue. If the private system doesn't meet these needs, government must--and we believe its cost will be much higher. I want to caution you that small businesses think it is fair for their rank and file workers to get a combination of public and private benefits in the same proportion to pay that key people do. But benefit plan rules have moved to where they are, in relation to pay, beginning to discriminate against the higher paid. And as growing numbers of decision makers in small businesses find their benefits held down by dollar limits, we have a concern about the impact--will this result in an expansion or contraction of the private system? We suspect the answer is obvious.

Small businesses are very cost conscious. Our customers have rapidly moved over recent years so that only a small fraction still provide first dollar medical coverage. The order of the day is deductibles and coinsurance. Small businesses also very much correlate their retirement programs with Social Security--so public and private retirement combined make for a good retirement, but avoid over-pensioning in relation to preretirement pay. As another indicator of cost concern, most small business welfare plans call for employee contributions to pay part of plan costs.

We ask you to think long range across the decades about how to keep the public/private partnership on employee benefits healthy--and steer away from appealing short-range actions which damage the long-range outlook. Reach for a stable, long range policy on a public/private partnership for employee benefits.

Company Name Bankers Life Company
Plans for our own employees

All Employees #5,500

TABLE 1

HEALTH BENEFIT AVAILABILITY, 1984

	Total Plan		Insured Part		HMO Part	
	#	%	#	%	#	%
$ 0-$ 9,999	447	8.2%	423	8.4%	24	6.4%
10,000- 19,999	3,627	66.7	3,364	66.5	263	70.1
20,000- 49,999	1,198	22.1	1,113	22.0	85	22.7
50,000- 99,999	138	2.5	135	2.7	3	.8
100,000 or more	25	.5	25	.5	0	.0
Total	5,435	100.0%	5,060	100.0%	375	100.0%

Company Name Bankers Life Company
Plans for our own employees

All Employees #5,500

TABLE 2

RETIREMENT PROGRAM AVAILABILITY, 1983

	Defined Benefit			
	Participate		Vested	
	#	%	#	%
$ 0-$ 9,999	189	4.8%	25	1.4%
10,000- 19,999	2,454	62.3	798	45.1
20,000- 49,999	1,133	28.8	794	44.9
50,000- 99,999	138	3.5	130	7.3
100,000 or more	24	.6	23	1.3
Total	3,938	100.0%	1,770	100.0%

Company Name Bankers Life Company
Plans for our own employees

All Employees #5,500

TABLE 3

RETIREE BENEFITS

Benefit	Number of Persons	Total Distributions or Cost	Year
Defined Benefit Plan Retirees in Pay Status	289	$1,800,000	1983
Defined Benefit Plan Retirees Survivors in Pay Status	37	175,000	1983
Defined Benefit Plan Survivors of Employees Who Died Before Retirement	30	100,000	1983
Defined Benefit Plan Vested Separated	320	N/A	1983
Retiree Health*	283	260,000	1983
Retiree Life	283	230,000 premium 1,200,000 RLR Deposit	1983

*Includes 227 Retirees
37 Survivors of Retirees
19 Survivors of Employees who died before retirement

Company Name Bankers Life Company--Our customer data

This data is for those 3,662 of our plan sponsor customers where The Bankers Life has wage and salary data in its records.

TABLE 4

RETIREMENT PROGRAM AVAILABILITY, 1983

Annual Salary	Defined Benefit			
	Participate		Vested	
	#	%	#	%
$ 0-$ 9,999	27,508	15.8%	9,093	10.9%
10,000- 19,999	85,470	49.2	37,672	45.1
20,000- 49,999	56,221	32.3	33,095	39.6
50,000- 99,999	4,003	2.3	3,020	3.6
100,000 or more	722	.4	635	.8
Total	173,924	100.0%	83,515	100.0%

STATEMENT BY RONALD PEARSON, PRESIDENT, HY-VEE FOOD STORES, INC., CHARITON, IA

Mr. PEARSON. Thank you, Senator.

I am Ron Pearson, president of Hy-Vee Food Stores in Chariton, IA. We are an Iowa-based company operating 134 supermarkets and 19 drugstores. We operate in the five States surrounding Iowa, including Iowa. We have been in business for a little over 53 years, and at fiscal year end employed 13,000 employees—now approximately 15,000. We are a privately held company and employee owned, and I would hope the Senator would note that I didn't call or write but decided to come personally and talk to this group about capital accumulation through profitsharing.

Senator PACKWOOD. If our problem is, with Chuck Grassley he's OK. [Laughter.]

Mr. PEARSON. Well, I would like to talk more specifically about the Hy-Vee Profitsharing Trust. We designed the employee trust to allow our employees to share in company profits. The trust also covers retirement benefits, catastrophic medical expenses not covered by insurance, and dependent education in case of parent hardship.

At fiscal year end we had almost 6,800 employees that were participants. Over 85 percent were ages 19 to 44, and 15 percent were ages 45 to 70. Sixty-nine percent earned less than $20,000 a year. Eighty-one percent earned less than $25,000, and over 98 percent earned less than $50,000.

We started our plan in 1960 and now have a participant equity in excess of $75 million.

We thought three things were important when we designed the plan—how soon you can get in, how long it takes to be 100 percent vested, and how much you get. So we elected to allow participants to be eligible at age 19. We also elected to fully vest a participant after 10 years by graded vesting. We elected to establish a fixed formula for company contribution rather than have a board of directors determine that amount. That has averaged almost 25 percent of pretax company profits since we started the plan.

Now, how is this useful? We think that the plan demonstrates that rank and file workers are provided outstanding benefits, and the plan predominately covers low- and middle-class workers; it is not top heavy.

Our plan was designed to help our employees accumulate capital, and we think that anything that disturbs this accumulation will not be in the best interest of the rank and file of Hy-Vee and may cause our employees to look to the government for more benefits.

Thank you.

Senator PACKWOOD. They absolutely will. Mr. Storey.

[Mr. Pearson's written testimony follows:]

Statement

of

HY-VEE FOOD STORES, INC.

Chariton, Iowa

on

FRINGE BENEFITS

Presented by

Ronald D. Pearson
President and Chief Operating Officer

Before the

Senate Committee on Finance
Subcommittee on Taxation and Debt Management

July 27, 1984

I'm Ron Pearson, President and Chief Operating Officer of Hy-Vee Food Stores, Inc., Chariton, Iowa. We are an Iowa based company operating 134 supermarkets and 19 drugstores, 153 retail units. We operate in six states--Iowa, Missouri, Minnesota, Illinois, Nebraska and South Dakota. Hy-Vee has been in business for 53 years; last year's sales were $1,100,000,000. At fiscal year end we employed 13,505 employees; 62% were parttime of which many are highschool or college students.

We are a privately held company, employee owned, with the largest stockholder having no more than 14½% of the stock.

I'm here today to comment on capital accumulation through profit sharing. Hy-Vee has both a salary bonus system based on individual profit center results and an employee profit sharing trust. With both of these systems we like to think we're a very employee benefit oriented company.

We would like to give some information about our employee trust. We designed the employee trust to allow our employees to share the company profits, building more job satisfaction. Also the trust is to cover retirement benefits, if the employee wishes, catastrophic medical expenses not covered by insurance, and dependent education in case of parent hardship.

First, some facts about our profit sharing trust plan. At fiscal year end 6,790 employees were participants, 85.15% between the ages of 19 and 44; 14.73% between 45 and 70 years of age and .12% over 70 years. Out of all these participants 69.13% earned less than $20,000 per year; 81% earned less than $25,000 and over 98% earned less than $50,000 per year (table is attached showing details).

Additional details about our plan: We started our plan in 1960 with a company contribution of $127,606.00 and have now grown to a total value of participants' equity of $75,675,285.00. The plan has grown through healthy company contributions, forfeitures, and a good earnings record (table attached showing details).

We felt three things were important for our employees when we were designing our profit sharing plan:

(1) How soon you can get in;

(2) How long it takes to be 100% vested;

(3) How much you get.

Hy-Vee has elected to make participants eligible at age 19; thus, allowing many of our parttimers to accumulate some capital while in school. We have also elected to fully vest a participant after ten years by "graded vesting" and have a graduated scale for vesting between two years and ten years, i.e., five years 40%, six years 50%, nine years 80%, ten years 100%.

We have also elected to establish a fixed formula for company contributions rather than have the Board of Directors determine the amount each year. We have averaged approximately 25% of pre-tax company profits contributed to the trust over the past several years.

Why is this data useful to you? We think our plan demonstrates that rank and file workers, including our 200 union employees, are provided outstanding benefits. Also the plan covers predominately low and middle income workers; it is ostensibly not "top heavy." I would like to give you some of the examples of some of the employees who have accumulated capital through this plan.

(1) Employee #1 - Knoxville, Iowa, parttime employee; started 1977 at age 16; terminated six years later at age 23 after completing college. He accumulated vested capital of $1,488.37.

(2) Employee #2 - Marshalltown, Iowa, parttime employee; started in 1972 at age 19; terminated twelve years later. She was 100% vested; she wanted to spend more time with her family. Her trust account balance was $11,952.54.

(3) Employee #3 - Clarinda, Iowa, started at age 26, a full time grocery employee; deceased June, 1984, at age 57; 100% vested; trust account to his wife of $48,851.40.

(4) Employee #4 - Chariton, Iowa, full time truck driver; started at age 19; deceased March, 1984, age 53; vested 100%; trust account to his wife of $83,449.52.

(5) Employee #5 - Albia, Iowa; employed June, 1940, at age 20; retired in 1983 at age 64; full time grocery employee; trust account balance of $50,549.88.

(6) Employee #6 - Sioux Falls, South Dakota, employed June, 1977; age 16; parttime clerk; terminated in March, 1984; vested trust account balance $1,938.12.

(7) Employee #7 - Marion, Iowa; employed August, 1977; age 16; parttime clerk; terminated March, 1984; vested trust account balance $2,148.87.

(8) Employee #8 - Trenton, Missouri; employed May, 1967; Age 47; full time grocery clerk; retired January, 1984; vested trust account balance of $38,303.26.

Our plan was designed to help the employees accumulate capital, whether it be a parttime student or a long time retiree. We believe that any changes which are made to disturb this accumulation will not be in the best interest of the rank and file employees of Hy-Vee and may cause them to look to the government for more of their needs.

Company Name Hy-Vee Food Stores, Inc.
Plans for our Employees' Trust

TABLE 1

EMPLOYEES' TRUST, 1983

1983 PARTICIPANTS

AGE GROUP	FULL TIME	REGULAR TIME	PART TIME	TOTAL EMPLOYEES	PER CENT TO TOTAL
0-18	-0-	-0-	-0-	-0-	.00
19-44	2,872	1,031	1,811	5,714	84.15
45-70	702	235	131	1,068	15.73
Over 70	2	-0-	6	8	.12
Total	3,576	1,266	1,948	6,790	100.00

WAGE GROUP	FULL TIME	REGULAR TIME	PART TIME	TOTAL EMPLOYEES	PER CENT TO TOTAL
0 - 5,000	6	23	462	491	7.23
5,000 - 10,000	124	686	1,405	2,215	32.62
10,000 - 15,000	517	493	76	1,086	16.00
15,000 - 20,000	839	58	5	902	13.28
20,000 - 25,000	787	6	-0-	793	11.68
25,000 - 30,000	587	-0-	-0-	587	8.65
30,000 - 35,000	389	-0-	-0-	389	5.73
35,000 - 40,000	138	-0-	-0-	138	2.03
40,000 - 45,000	43	-0-	-0-	43	.63
45,000 - 50,000	28	-0-	-0-	28	.41
50,000 - +	118	-0-	-0-	118	1.74
Total	3,576	1,266	1,948	6,790	100.00

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Company Name Hy-Vee Food Stores, Inc.
Plans for our Employees' Trust

Table 2

EMPLOYEES' TRUST, 1983

FISCAL YEAR	TOTAL PART.	COMPANY CONTRIBUTION	PER CENT OF PRE-TAX PROFIT	---PERCENTAGE FOR DISTRIBUTION--- CO. CONT. % OF WAGES	FORFEI-TURES	EARNINGS PER CENT
1960	561	$ 127,606	16.383	3.6216989	-0-	.6514429
1961	654	124,188	15.756	2.9999400	5.7773930	4.6773020
1962	738	219,013	19.569	4.9065823	7.9091210	(11.1047078)
1963	827	414,959	25.000	7.6603310	4.9749879	9.0212214
1964	941	476,785	25.000	7.7313399	4.4422754	6.8161863
1965	1,024	558,811	25.000	8.4152086	3.2570834	8.7542446
1966	1,101	675,509	25.000	8.7462498	4.1579145	7.7548308
1967	1,206	695,064	25.000	7.9638827	3.5774660	12.9451829
1968	1,291	548,542	20.669	5.8996191	2.5204067	8.8470066
1969	1,338	900,337	25.000	8.6607828	3.2026641	6.0150168
1970	1,568	1,010,975	25.000	7.6769084	2.4799288	6.7975835
1971	1,827	1,047,413	23.651	6.4283721	1.7636118	10.4075341
1972	2,007	1,298,239	25.000	6.9681312	3.1065323	8.2636359
1973	2,125	1,623,933	25.000	7.8461822	2.6635361	7.3930474
1974	2,287	2,276,433	25.000	8.8340190	2.7051493	(1.5934195)
1975	2,515	2,614,433	25.000	8.3029266	1.9216305	13.3010669
1976	2,713	3,447,566	25.000	9.0131974	2.5289300	16.1065776
1977	3,620	3,222,987	25.000	6.9390049	.7271988	9.8795616
1978	4,098	4,024,645	25.000	7.1723166	.7735060	9.9662529
1979	4,584	4,394,230	25.000	6.3896294	.7494020	9.3887776
1980	5,081	4,735,510	25.000	5.9541113	.6340154	7.7457876
1981	5,444	5,643,060	25.000	6.2359841	.6385828	3.6703072
1982	6,156	5,141,420	24.126	4.9050808	.5563821	17.1789124
1983	6,790	5,414,405	24.101	4.7045339	.5539783	14.3021840

STATEMENT BY JAY STOREY, VICE PRESIDENT, THE MAYTAG CO., NEWTON, IA

Mr. STOREY. Thank you, Senator Packwood.

We at Maytag also think Chuck Grassley is OK. [Laughter.]

And we were very happy to have Senator Durenberger in Iowa, and also you, Senator Packwood. So we are communicating with you here recently.

I have been asked to tell you just how we go about establishing the level of benefits at the Maytag Co. But first, before I do, let me tell you who enjoys these benefits. Ten percent of the people receiving benefits under the medical and retirement programs at Maytag earn between $10,000 and $20,000 a year. Eighty-seven percent earn between $20,000 and $50,000, and only 3 percent of those in the plans earn over $50,000 per year.

Now, it seems like some feel that management sits around thinking up ways to give new benefits to themselves and to other people. In actual fact, management spends a much greater part of their time worrying about the cost of their current benefit plans and what they can do to control these costs. Any new benefit that is granted is an additional cost and must be added to the cost of our product and affects our ability to compete in a very competitive market.

In my 30-plus years at the Maytag Co. our benefit programs have developed as a direct relation to our negotiation with the UAW. Now, this happens about like this: Every 2 or 3 years when the contract expires, the union submits to the company demands which include a long dream list of improvements to current benefit plans and new benefit plans—along, of course, with their wage increases. In typical give-and-take fashion, negotiations reduce these demands to a level acceptable to both parties, hopefully. This settlement level is based on the total amount of money which the company is willing to spend for both wages and benefits in that particular round of bargaining. Each benefit improvement is carefully and meticulously costed and included in the total package of improvements.

The company finally says to the union, "We really don't care how you divide up this money between wages and benefits, but there is no more money to spend." The benefit package thus negotiated becomes the model, with minor variations for the rest of the organization, including top management.

Of course, the company is motivated to not let too large a portion of compensation be in the benefit area, because in the competitive labor market of hiring new employees it is the wages that attract and hold good employees, particularly the younger ones. You just don't get full credit for dollars spent on benefits.

The question has been posed: What would be the outcome if benefits such as medical and retirement were immediately treated and taxed as regular income? It is my belief that, if this is done, unions would more and more opt for negotiating wage increases only and rely on the employee to determine and purchase what benefits they individually wanted.

Since the company feels that they do not get full value for money spent for benefits, they would also be willing to let this happen. I submit this would result in employees not buying the needed level of retirement and medical benefits; more and more people would then turn to the Government and to welfare for relief.

Senator PACKWOOD. I know exactly what you mean about the level of compensation you are going to pay is determined. I practiced labor law for 5 years, negotiating contracts for employees—mostly multiemployer bargaining, but some individual—and you are absolutely right. You sit down and say—this was 20 years ago—"We can afford $5 an hour. Divide it up within reason any way the union wants to divide it up, but that is all we are going to pay, and beyond that we will take a strike." I discovered that the real key to the secret of collective bargaining was in convincing the union you would not go beyond $4.85. If you could convince them of that and save 15 cents an hour, that was an immense saving to your client.

Let's see—Mr. Munson is next.

[Mr. Storey's written testimony follows:]

July 27, 1984

STATEMENT OF J.R. STOREY IN CONNECTION WITH THE HEARINGS OF THE SENATE FINANCE SUB COMMITTEE ON TAXATION AND DEBT MANAGEMENT ON THE SUBJECT OF FRINGE BENEFITS.

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The attached set of statistical tables show that 10% of people receiving benefits under the Medical and Retirement programs at Maytag earn between $10,000 and $20,000; 87% earn between $20,000 and $50,000 and only 3% of those in the plans earn over $50,000 per year.

My assignment today is to tell you how benefit levels are established at Maytag. It seems that some feel management sits around thinking up ways to give new benefits to themselves and other employees. In actual fact, they (management) spend much more time worrying about the cost of their current benefit plans (medical, dental, vision, retirement, etc.) and what they can do to control these costs. Any new benefit that is granted is additional business expense and adds to the cost of our products.

In my 30 odd years at Maytag, our benefit programs have developed as a direct result of contract bargaining with the UAW. This procedure unfolds like this:

(a) The union submits its demands which includes a long list of improvements to current benefit plans and for new plans, along with their proposed wage increases.

(b) In typical give and take fashion, negotiations reduce the demands to a level acceptable to both parties. This settlement level is based on the total amount of money which the Company is willing to spend for both wages and benefits in that particular round of bargaining. Each benefit improvement is carefully and meticulously costed and included in the total cost of the package of improvements or concessions as the case may be.

(c) The Company usually says to the union -- we don't care how you divide the money up between wages and benefits, but there is no more money.

(d) The union decides which benefits to select by sampling and/or sensing the needs and desires of the membership.

The benefit package thus negotiated becomes the model with minor variations for the rest of the organization, including top management.

At Maytag, the following plans are exactly the same for management as union employees:

(a)	Medical	(e)	Accidental Death & Dismemberment Ins.
(b)	Dental	(f)	Holidays
(c)	Vision	(g)	Dependent Life Ins.
(d)	Drug	(h)	Educational Assistance Program

The retirement plan for management is based upon a percent of the highest five consecutive years of earnings out of the last ten, where union employees currently receive $17.50 per month per year of credited service. This works out that the average hourly employee gets a higher percent of final wages than management employees receive. This is common throughout industry.

The Company is motivated to not let too large a portion of compensation (wages and benefits) to be in the benefit area because in the competitive labor market of hiring new employees and, to a certain extent, retaining current employees, it is the wages and salaries that attract and hold good employees, particularly the younger ones. You just don't get full credit for dollars spent for benefits.

The question has been posed -- "What would the outcome be if benefits provided by the employer were treated and taxed as regular income"? It is my belief that if this was done, unions would more and more opt for negotiating wage increases and rely on the employee to determine and purchase what benefits they individually wanted. Since the Company feels that they do not get full value for money spent for benefits, they also would be willing to let this happen to a great extent. I submit this would result in employees not uniformly buying the needed level of retirement and medical benefits. More and more people would then turn to the government and welfare for relief.

Respectfully submitted,

Jay R. Storey - Vice President of Personnel

THE MAYTAG COMPANY
Newton, Iowa

attachment

Company Name (Optional) Maytag (Parent Only)

[X] All Employees # 3,110
[ ] Salaried Only #

TABLE 1

EMPLOYEE BENEFIT DOLLAR COST, BY CATEGORY, 1983

Benefit	Employer Payment $ (In Thousands)	Per Employee $
Total Benefits	$ 38,069	$ 12.2
Legally-Required Employer Payments	7,766	2.5
Social Security	5,303	1.7
Unemployment Compensation	1,971	0.6
Workers' Compensation	479	0.2
Other Payments	13	-
Discretionary Taxable Benefits	9,780	3.1
Time Not Worked	5,877	1.9
Rest Periods	3,723	1.2
Other Taxable Benefits	180	-
Discretionary Tax-Favored Benefits	20,523	6.6
Defined Benefit Pension Plans	10,004	3.2
Capital Accumulation Plans	-0-	-
Disability Plans	256	0.1
Group Health and Life Insurance	-	
Active Workers	6,924	2.2
Retirees	3,283	1.1
Other Tax-Favored Benefits	56	-

Company Name (Optional) Maytag (Parent Only) [X] All Employees # 3,110
[ ] Salaried Only #

TABLE 2

EMPLOYEE BENEFITS PERCENTAGE COST, BY CATEGORY, 1983

Benefit	Employer Payments as Percent of Wages and Salaries	Employer Payments as Percent of all Benefits
Total Benefits	44.5%	100.0%
Legally-Required Employer Payments	9.1	20.4
Social Security	6.2	13.9
Unemployment Compensation	2.3	5.2
Workers' Compensation	0.6	1.3
Other Payments	-	-
Discretionary Taxable Benefits	11.4	25.7
Time Not Worked	6.9	15.4
Rest Periods	4.3	9.8
Other Taxable Benefits	0.2	0.5
Discretionary Tax-Favored Benefits	24.0	53.9
Defined Benefit Pension Plans	11.7	26.3
Capital Accumulation Plans	-	-
Disability Plans	0.3	0.7
Group Health and Life Insurance	-	-
Active Workers	8.1	18.2
Retirees	3.8	8.6
Other Tax-Favored Benefits	0.1	0.1

Company Name (Optional) Maytag (Parent Only)

[X] All Employees # 3,110
[ ] Salaried Only # ________

TABLE 3

RETIREMENT PROGRAM AVAILABILITY, 19 83

	Defined Benefit				Employer Capital Accumulation				401(k)			
	Participate		Vested		Participate		Vested		Participate		Vested	
	#	%	#	%	#	%	#	%	#	%	#	%
					N/A				N/A			
$0-$ 9,999	-	-	-	-								
10,000- 19,999	310	10	144	6								
20,000- 49,999	2,709	87	2,019	90								
50,000- 99,999	85	3	79	4								
100,000 or more	6	-	6	-								
Total	3,110	100%	2,248	100%		100%		100%		100%		100%

Company Name (Optional) Maytag (Parent Only) [X] All Employees # 3,110
[ ] Salaried Only # ______

TABLE 4

HEALTH BENEFIT AVAILABILITY, 1983

	Group Insurance #	Group Insurance %	125 Plan #	125 Plan %	HMO #	HMO %
			N/A		N/A	
$0-$ 9,999	-	-				
10,000- 19,999	310	10				
20,000- 49,999	2,709	87				
50,000- 99,999	85	3				
100,000 or more	6	-				
Total	3,110	100%		100%		100%

Company Name (Optional) Maytag (Parent Only) /X/ All Employees # 3,110
/ / Salaried Only #

TABLE 5

RETIREE BENEFITS

Benefit	Number of Persons	Total Distributions or Cost (In Thousands)	Year
Defined Benefit Plan Retirees in Pay Status	# 1,502) Pension Benefits Paid:	$	1983
	)- Retirement	8,802	
	Death	132	
Defined Benefit Plan Retirees Survivors in Pay Status	# 198)	$	1983
Defined Benefit Plan Vested Separated	# 225	N/A	19
Capital Accumulation Plan Retirement Age Distributions	# N/A	$ -	19 -
Capital Accumulation Plan Termination Distributions	# N/A	$ -	19 -
Retiree Health	# 1,827	$ 3,283	19
Retiree Life	# 1,515	$ *	19
Retiree Other	# -	$ -	19 -

* Cost for this item is not available separately - cost is included in total pension cost of $10,004,000.

STATEMENT OF MICHAEL MUNSON, DIRECTOR OF COMPENSATION AND BENEFITS, MEREDITH CORP., DES MOINES, IA

Mr. MUNSON. Thank you, Senator.

My name is Mike Munson. I am the director of compensation and benefits for Meredith Corp., headquartered in Des Moines, IA. Meredith Corp. has about 4,800 full-time employees in the corporation and its affiliated branches.

I have been asked to talk a little bit about our defined benefit pension plan this morning. Our defined benefit plan for our bargained employees is based on earned-service credit of so many dollars per year of service. For our nonbargained employees we have a final 5-year plan with a Social Security offset. The net result in any of these circumstances is a lifetime guaranteed pension for our employees.

In 1983 our defined benefit plan distributions—51 percent of the dollars went to employees making $20,000 or less, 94 percent to those making $50,000 or less.

In 1970 and 1971 the corporation was wrestling with how to adjust employee pensions after the employee had retired. We considered several different options, considered some kind of a formula plan, considered relying on ad hoc adjustments as situations demanded, considered a variable annuity program where the retired lives reserves were invested in the stock market, the retire simply rode the roller coaster up and down. They may have retired at $100 a month, a year later gone up to $120, and a year later gone back down to $80.

What we finally chose, with some cooperation from the Bankers Life Co., was a modified variable annuity. We moved all of our retired live reserve dollars into the stock market, and we modified the variable annuity to the extent that employees would never get less than the original amount at which they retired—they would never go below that particular floor amount.

What we have said to our employees, we have established a bogey of 5.25 percent performance in those dollars in the stock market. Seventy-five percent of any gain over that 5.25 percent goes directly to our retirees on a once-a-year adjustment. Twenty-five percent of those dollars go into the stabilization or what we refer to as the rainy day fund.

We have 700 employees who are all subject to this modified variable annuity concept, except for those that took cash allowances when that was available.

We have had this program in effect for 14 years. The first couple of years we saw pluses. For that mythical employee with $100, it went to $102, then went to $104. We then had 3 years in a row where the unit value of the asset dipped way below $100—it went down in the $80 vicinity. We maintained the $100 floor as we had promised; used the rainy day fund and also used other corporate assets.

For the next 9 years, 7 out of those 9 years have seen pluses, to the extent now that an employee who retired in 1971 on a $100 pension is now at $190. Of course, it depended on when you retired as to where you are in this stream of earnings.

The compounded growth rate for an employee who retired in 1971, through today, is about 3 percent; for someone who retired in 1975 it has averaged about 5.75 percent. For someone retired in 1978, he has seen 9 percent growth over this period of time.

Senator PACKWOOD. Just out of curiosity, what caused the immense growth for this year.

Mr. MUNSON. I think you should ask Bankers Life. I'm sure they are very proud of their successes with their account management.

Senator PACKWOOD. Congratulations. That's a whale of an increase in 1 year.

Mr. Shonsey. Shonesy. Which is it?

Mr. SHONSEY. It's Shonsey. It used to be O'Shaunessey, but it somehow was cut up in the process.

[Mr. Munson's written testimony follows:]

STATEMENT OF MEREDITH CORPORATION, DES MOINES, IOWA IN CONNECTION WITH THE HEARINGS OF THE SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ON THE SUBJECT OF FRINGE BENEFITS JULY 26, 27 and 30, 1984.

In 1971, Meredith Corporation established a modified variable annuity feature for its pension plans. Instead of adopting any type of Cost of Living Adjustment plan or relying on an ad hoc adjustment, the Company selected the Modified Variable Annuity approach. In the process, the Company changed its Retired Lives Reserve Assets from fixed income investments to a common stock portfolio.

In a true variable annuity situation, the retired employee has all the risk and all the reward. If the investment performance is good, his/her pension will go up; if the investment performance is bad, his/her pension will go down and can be less than the original amount. Meredith, with the cooperation of Bankers Life Company, "modified" that situation into a far less risky circumstance for the employee and, in fact, provided upside potential while guaranteeing a "floor" amount.

Meredith Corporation pension plans are defined benefit plans. Bargaining employee plans earn X amount of dollars of pension credit for each year of service. Non-bargained employees are in a "final five" Social Security offset plan. Each individual who retires has a lifetime guaranteed monthly pension. The Modified Variable Annuity provides the potential for that pension to increase on a yearly basis, but it can never fall below the original guaranteed "floor" amount.

The following paragraph describes the operation of the Variable Annuity:

> "The amount of your monthly income payment in retirement may increase, depending on the investment performance of the variable annuity fund. Each July 1st, your monthly income is subject to change. If the fund increases by more than 5 1/4%, your monthly payments will increase. If the fund increase is less than 5 1/4% or decreases, your monthly benefits will decrease. In no event will the payment fall below the amount established as your original retirement benefit."

In order to guarantee that the payment will not fall below the original retirement benefit, only 75% of the excess of fund investment performance over 5 1/4% is used to increase the Variable Annuity benefits. The other 25% is placed in a stabilization reserve, or "rainy day" fund used to help make up shortfalls when investment performance is less than satisfactory.

The 5 1/4% "bogey" was the average rate of return on fixed income investments earned by the Meredith plan during the five years preceding adoption of the Variable Annuity. Meredith would not be "keeping" more of the return on Retired Lives funds than it had been in the recent past.

Approximately 700 retirees of the Meredith Corporation are currently receiving Variable Annuity benefits under the plan. All retirees are subject to the Variable Annuity with the exception of those who elected cash benefits when that option was available prior to 1977.

The following is a history of changes in Variable Annuity funds and retirement benefits:

Date	Net* Fund Performance	Monthly Benefit
71	N/A	$100.00
1/1/72	+2.36%	$102.36
1/1/73	+2.01%	$104.42
1/1/74	-14.71%	$100.00
1/1/75	-20.65%	$100.00
1/1/76	+6.81%	$100.00
7/1/76	+40.8%	$106.29
7/1/77	+2.84%	$109.31
7/1/78	-1.80%	$107.34
7/1/79	+7.53%	$115.42
7/1/80	+10.17%	$127.16
7/1/81	+17.40%	$149.29
7/1/82	-1.95%	$146.38
7/1/83	+5.21%	$154.01
7/1/84	+23.48%	$190.17

*Net = 75% of amount in excess of 5 1/4%.

An employee who retired in 1971 with a $100.00 original retirement benefit is now at 190.17 or plus 90% over 13 years. The actual compounded value of the stream of benefits is slightly above 3% per year since 1971. A 1975 retiree received a compounded stream of payments at about 5 3/4%. In recent years, the fund performance has resulted in even more dramatic changes: A 1978 retiree pension stream has compounded at about 9%; 1980 at about 9 1/2%.

Variable Annuity benefits from January 1, 1974 to June 1, 1976 actually fell below the original retirement benefit. The stabilization (rainy day) fund plus additional corporate dollars were used to insure that retirees were paid the amount of their original retirement benefit.

The "rainy day fund" is currently equal to approximately 20% of the present value of all Variable Annuity payments currently being paid to retirees. The original retirement benefit guarantee seems assured. In any event, it's unlikely there will be any sizeable application from the reserve fund for some time since most retirees are receiving 90% more than their original benefit.

STATEMENT BY EDWARD SHONSEY, DIRECTOR, HUMAN RELATIONS, PIONEER HI-BRED INTERNATIONAL, INC. CO., DES MOINES, IA

Mr. SHONSEY. I want to thank you gentlemen for allowing me the opportunity to speak with you today concerning this topic and being one of the "other 109" that you referenced, Senator Packwood.

My name is Ed Shonsey. I am with Pioneer Hi-Bred International. We are an agribusiness company which researches, produces, and markets agricultural products throughout the world. We have regular employees, all of whom are eligible for an employee benefit program, and they are stationed throughout the United States and also overseas.

It is important to note, of these individuals 39 percent make less than $20,000 and our average salary is just slightly less than $25,000 per year. It is, therefore, important in our employee benefit program to provide them some protection for catastrophic relief and also to maintain their livelihood.

The profile of our work force is also changing; 39 percent of our work force now are women or other minorities. This is a 17-percent increase since the past year, and we expect this trend to continue. This has injected additional needs into our program and has caused us to take a look at it, and appropriately so. With our employees we are reviewing, renewing and redoing our program as appropriate. We have decided to manage this change versus being managed by it.

Now, an example of that, is that we realize that business as usual isn't necessarily good business and that we need to manage differently, and we need to use some clout as Senator Packwood referenced earlier this morning. An example of how we have done this is in our health care management program. We have attacked costs through coalitions with other companies in the public sector, we have provided alternative delivery systems and choices for employees to manage, and we have redesigned our benefit program to eliminate the first-dollar payment. We have also provided greater education for an informed and sensitive consumer, so that they will "use their noodles" as Senator Durenberger mentioned earlier.

We have also looked at a long-term approach to be pro-active through a wellness program and provide employees a incentive to manage their own health.

The results are clear for Pioneer. We have reached a level of 443 patient-days per 1,000 compared to a national of 1,000. We have an average stay of 4.3 days versus the national average of 6.9. Our wellness program, which is voluntary and is also offered to our spouses, has reduced the detection of serious abnormalities to less than 1 percent, compared to over a 6-percent rate in previous years, having when we just started a few years ago.

The bottom line is, we have reduced our costs 13 percent while increasing our work force, compared to the 133 percent increase nationally, over the last 7 years.

Our goal is simple: We care about people—not only because it is morally right but because it makes good practical business sense.

And that's what we are here to do, to provide them a program, the best program we can for the resources spent.

We also recognize the interdependence of the private sector and the public sector, as I referenced, and the fact that the credibility crisis between them needs to reduce. That is why I am here today. I am representing the customers of our benefit program—our employees themselves.

Thank you.

[Mr. Shonsey's written statement follows:]

Statement of Pioneer Hi-Bred International Inc. Co. by Edward Shonsey, Director of Human Resources

Pioneer Hi-Bred International, Inc. Co. is an agribusiness company which is a world leader in the research, production and marketing of seed products. It employs 2,200 regular employees throughout the United States, all of whom are eligible for the Company's employee benefit program. Pioneer's payment of benefits as a % of wages for these individuals is 47%. 39% of the employees earn less than $20,000/year and 95% earn less than $50,000/year. Benefits, therefore, are an essential part of maintaining an employee's standard of living and livelihood as well as protection against catastrophic costs due to illness or other factors. This is best evidenced by two examples of women employees experiencing catastrophic illnesses in their families during the past 12 month period, in which Pioneer paid over $100,000 in each circumstance for medical costs. Payment of these costs would not have otherwise been possible by these individuals.

Pioneer is a Company highly committed to its people and their continued growth, development and satisfaction. "People make Pioneer" is a philosophy well entrenched, not only because it may be morally right, but also because it makes good, practical business sense. In order for the Company to grow and prosper, people will also need to develop. This will happen by insuring that their basic needs are met and protection will be there to allow them to be more productive. The goal of Pioneer's benefit program is to do just that while simultaneously working to have its employees become better managers of these costs through choices and education, hence sharing the concern for the spiraling effect of the benefits costs.

Pioneer has experienced change in its employee profile. It has chosen to manage this and other changes versus being managed by them. Today 30% of its regular workforce are women and minorities. This is a 17% increase from the previous year and a significant change in its agriculturally based history. This change in profile has also injected additional needs by the employee for other or updated benefits which Pioneer strives to meet through close contact with the employees. If the needs were not met within the Company, the burden would fall toward the public sector. Pioneer's payment for total benefits in 1983 was $27 million or $12,748 per employee. Pioneer has, therefore, realized that business as usual is not always good business and that the change and higher costs need to be dealt with via mutual efforts by the employee, employer and the public sector. It is necessary for all these groups to review programs, renew those that remain viable and redo those that are not.

Pioneer has taken a sixfold approach to offset costs and encourage the marriage or partnership between the three groups. These six include:

1. coalition
2. alternative delivery systems
3. utilization review
4. benefit plan design
5. wellness benefits

6. employee awareness

An example of the effectiveness of this approach and results is seen in the health care cost area.

Pioneer has long been an advocate of reduced medical costs but also it realized that neither it, nor the public sector alone could satisfy total needs or resources to control costs. It, therefore, cosponsored with key corporate and public sector leaders in Iowa a coalition approach to attack health care costs and learn to manage the system so that we get optimum results for the resources spent. This endeavor to restructure Iowa's health care marketplace to achieve fundamental, long-term improvement is statewide in scope. The unique challenge is evident as affirmed by Willis B. Goldbeck, President of the Washington Business Group on Health who stated: "Folks in Iowa would cringe at being called radical, and even reform would sound a bit strong to many there. To an outsider, what Iowans have done with and to their medical care system in the past four years is clearly radical, and something of a lesson for many other parts of the country." This reshaping in which Pioneer participates includes: the establishment of a health data commission which makes available information on doctor's and hospital's fees; formation of community and state level coalitions of business, labor consumers and other groups who, in the past, worked separately; and the establishment of a private, non-profit Health Policy Corporation of Iowa, which was formed in May, 1982. This corporation successfully acts as a catalyst and forum for dialogue for all interest groups per the enclosed brochures. The coalition approach has, therefore, enabled Pioneer to successfully address key information and issues more effectively to lower costs. Additionally, Pioneer has redesigned its plan to provide options for the employee to manage his or her costs through alternative sources, such as Blue Cross/Blue Shield and Health Maintenance Organizations. Presently we are now analyzing additional options such as self-administration of health care costs, which we have already done for our 300 retirees.

Results in Pioneer are significant. Pioneer has replaced the traditional "first dollar" insurance with cost sharing plans that include economic incentives to receive needed care from the most appropriate and cost-efficient providers. Correspondingly Pioneer has been able to keep the Company's health care costs below the national average. Examples of this include reaching a level of 443 patient days per 1,000 with only 93 admissions per thousand vs. a national average of 1212.5 per 1,000 for 1982. Additionallly, the level of our people staying in the hospital is an average of 4.3 days compared to a national average of 6.9 days. Our trend is also a positive one since these results compare to 826 per 1,000 for Pioneer in 1979 and 577 per thousand in 1982. Average length of stay in 1981 was 6.2 days and 5.2 days for 1982. Clearly then, health care is a shared concern by Pioneer's employees.

Additionally it has been recognized by Pioneer that attention to improving employee and dependent health through wellness programs is essential to proactively promote cost savings in the long term. Pioneer began its Health Guard program in 1979 and offers all employees and their spouses an annual health screen which includes vital signs and a urinalysis. Employees also receive a complete blood chemistry analysis and a hematology test for white and red cell counts. The results of the test are confidential. They are mailed to each employee or spouse with an easy to comprehend explanation designed to increase the participant's overall understanding of health. Each health screen costs the company approximately $48.00. Approximately 98% of the employees and 73% of the spouses participate in the health screen. In addition to the health screen, two incentive programs are offered:

1. TOTE (Trim off the excess) designed to encourage employees and spouses to lose excessive weight. (Each person is paid $5 per pound lost until desired weight is reached. If the desired weight is maintained for one year, additional incentives are provided.)
2. COP (Cut out puffing) designed to pay an employee or spouse $150 to quit smoking for one year.

Since these programs have been operational, measurable results include:

a. During the first year, 6% of those screened discovered serious abnormalities. In 1983 less than 1% had serious abnormalities.
b. Approximately 60% of all overweight employees

participate in the TOTE program with 90% achieving weight loss.

c. An estimated 37% of the Pioneer population smoked in 1979. As of 1983, 40% of these people have stopped for at least two years as a result of the program.

These steps, as well as aggressive employee health education, have contributed to our overall cost management program. Pioneer's per-employee increase in health care costs decreased from 23% in 1980 to 10% in 1983.

The challenge remains clear for all facets of Pioneer's employee benefit program. Our disability benefits, life insurance, health, and dental are self insured so we pay for only the claims that are incurred. If tax incentives were the driving factor vs. cost containment, Pioneer would fully insure all of its benefits which would ultimately be more costly. The key for Pioneer, therefore, remains one of encouraging both private and public sectors to diminish the credibility crisis and enhance the marriage between business and government to most effectively address the issues. Pioneer's efforts, as well as Iowa's, are evidenced through its efforts to seek balance between private and public sectors, regulation and competition, and between providers and payers. We are making major investments in long term systems change toward making quality, affordable plans available. We request your help in participating in that long term approach with us.

Company Name (Optional) Pioneer Hi-Bred International, Inc.

☐ All Employees # 2,112
☐ Salaried Only #

TABLE 2

EMPLOYEE BENEFITS PERCENTAGE COST, BY CATEGORY, 1983

Benefit	Employer Payments as Percent of Wages and Salaries	Employer Payments as Percent of all Benefits
Total Benefits	47%	100%
Legally-Required Employer Payments	10%	21%
Social Security	.07%	15%
Unemployment Compensation	.02%	.03%
Workers' Compensation	.01%	.02%
Other Payments	0	0
Discretionary Taxable Benefits	22%	47%
Time Not Worked	8%	18%
Rest Periods	6%	12%
Other Taxable Benefits	8%	18%
Discretionary Tax-Favored Benefits	15%	32%
Defined Benefit Pension Plans	4%	7%
Capital Accumulation Plans	.003%	.01%
Disability Plans	.002%	0%
Group Health and Life Insurance	.05%	11%
Active Workers	.05%	10%
Retirees	.003%	.01%
Other Tax-Favored Benefits	.012%	.02%

TABLE 4

HEALTH BENEFIT AVAILABILITY, 1983

	Group Insurance		125 Plan		HMO	
	#	%	#	%	#	%
$0-$ 9,999	23	1			1	1
10,000- 19,999	728	38			65	45
20,000- 49,999	1,083	57			72	50
50,000- 99,999	69	4			3	2
100,000 or more	3	.001			2	2
Total	1,906	100%		100%	143	100%

Senator PACKWOOD. Gentlemen, you have all reemphasized, the point that becomes more and more obvious, that the bulk of these benefits go to low- and middle-income employees, no matter how you cut it and slice it.

Unfortunately, the examples that are cited as abuses are usually high-income employees in very small privately held corporations. Everyone generalizes from that and thinks that's what's wrong with fringe benefits.

It is the same problem we have in taxation generally; we can cure the abuses, and indeed we should, with antidiscrimination clauses. Unfortunately, so few people are affected it doesn't have much revenue effect.

Indeed, if we are worried about revenue and the loss of revenue, there is no way that we can tinker with these programs without affecting the broad, lower, and middle income people.

You have the same problem when we are talking about the deficit and raising money. There are loopholes to be closed, but we are not going to balance the budget by simply taxing the wealthy—there aren't enough rich. If we could confiscate all of the income above $100,000 a year, it would raise $76 billion, once, because nobody is ever going to make over $100,000 again, and that goose is therefore gone.

We have to get in our minds the fact that the abuses have to be cured. But that isn't going to solve the revenue problem. The philosophical question comes: Do we want to solve the revenue problem by limiting these benefits? Then, the ultimate philosophical question would be: If we limit them, do we think that is going to be the end of the request or the demand for them? If not, how are they going to be paid for? My hunch is, you are going to pay for them with taxes on your companies at a much higher rate than you pay now to provide the benefits and with much less satisfaction to your employees.

Dave.

Senator DURENBERGER. Mr. Chairman, I am very pleased that all of these people are here from Iowa. And from the standpoint of what this hearing is telling the world, hopefully, in terms of the reliability long-range of the employer/employee relationship, it's a tremendous learning experience for all of us to watch a State at work.

In my looking around for innovation in health care over the years, it strikes me that your county, or that Multnoma County, OR, is where a lot of innovative things have sprung out of. They have sprung out of the Twin Cities, the part that I represent. But now, the latest thing to hit all of us, thanks to the Wall Street Journal and to the fact that it is Roger Jepsen and not Chuck Grassley that is bringing all of us to Iowa, is that we are all discovering what wonderful things—you know, 'a big surprise'—that responsible employers and responsible employees can do if they are just given appropriate opportunities.

The other thing, I think if you look closely at just the health care side in Iowa—and I see one of you has the HPCI stuff attached here—is how important people are. I mean, Bob Burnett at Meredith—I am just picking one person; there are probably others. But the president, or chairman, or CEO, or whatever, went up against the whole establishment down there in Iowa, rallied all the rest of these folks behind him, and had to beat up on a whole lot of people. But they stuck to their guns in that State. I found my experience down there 2 weeks ago to be incredibly enlightening. In Minnesota you usually say, "If you can do it in Iowa, you can do it anywhere." [Laughter.]

The reality is, they are doing it a whole lot faster in Iowa than we are doing it statewide in Minnesota. And that's what I told them. And I had a bunch of CEO's sitting at a lunch there. I said:

> I'll bet you couldn't go to a comparable group of CEO's in Minnesota—which everybody brags about as being competition and choice—and find them as smart, knowledgeable, and committed as you find them in Iowa.

There is one nice thing that at least a couple of these witnesses—Mr. Shonsey, and Mr. Storey—have attached behind their statements, and that is a breakout of employee benefits percentage costs. It sort of gives you an interesting view of the legally required employer payments, the discretionary taxable benefits, the discretionary tax-favored benefits, and where some of this money goes. In both cases there is a fairly substantial chunk of the total under "time not worked", "rest periods", and that sort of thing.

I just maybe have a question of one or more of you, and that's in this whole business of "sick leave," which I happen to think is sort of an antiquated, very costly approach to this whole business, and we are really stuck with it in public employment, particularly at the local government level. They bargained to carry their so-called sick leave with them forever and all that sort of thing. It is a huge chunk of an employer's cost.

If you really wanted to do it right in your wellness programs—besides paying the $150 for not smoking for a year, as Mr. Shonsey does—you try to convert this whole concept of sick leave, which is really just a giveaway for a lot of people, into some kind of a wellness leave, and put the incentives for time off. Stop sending flowers to people in the hospital and send the flowers to people who don't go to the hospital—you know, that kind of a concept—and just deal with that section of the employee beneifts. Again, they fall into the category of costing us all something, because you are paying them salary for taking all that time off, and all the time not worked, and all those rest periods, and all that sort of thing. There is a pretty good chunk of revenue foregone there, too.

In Iowa, or in some of these companies, is there some effort to try to convert this concept of sick leave to something else? How do we deal with that issue?

Mr. Taylor.

Mr. TAYLOR. I might comment breifly about that, because it is something that we had that we abandoned. Maybe it is time to come back to it.

When I first started working for Bankers Life Co. over 30 years ago, we had a program where, if you were neither sick nor tardy for a month at a time, you earned an extra half day of vacation. And the way we controlled the timing on that was whether you punched in on the time clock. Then it became undignified to punch in on the time clock. Somewhere in the process it was changed around so you just had sort of a special time. It is now not motivational, for the very point that you are saying. We do have a wellness program, but I am very interested in your comments. We may well think about something like that.

Senator DURENBERGER. There are some companies trying it. It is real hard to do—you have to be small, and you have to be privately owned, and that sort of thing.

Mr. SHONSEY. Senator, I would like to also comment on that. I fully agree with your statement, and we are looking at that. It reminds me—I once had a person tell me never to read the newspaper in the morning because everything in it is negative, and you should read it at night so you don't ruin your day. I think the topic is true, also, for when you say "sick leave." It automatically connotes a negative rather than a positive. The thrust we are taking, and we are struggling with it as you referenced because it is difficult, is to address how do we increase and provide those benefits for people with time on the job versus time off the job, and make it more fulfilling. Hence, from that sheer pragmatic sense that I referenced earlier, we are going to be more productive also, and the country will also be more prosperous.

Senator DURENBERGER. Mr. Storey.

Mr. STOREY. I think you said this but I just want to make sure we all understand. The reason we put this in here is to make sure that it is understood that when people talk about benefits approaching 40 percent, that a lot of what they are putting in there is taxable, and all of this money is taxable, both the discretionary and the big hunk of it that is legally required, that we have to give. So the discretionary is much less than that 44 percent.

On your particular question, we worked very, very hard on that. I believe that for true sickness we should pay, and that we must keep sickness. We are experiencing in the Maytag Co. with a program that does reward people for not being absent, and they earn time off. I would say, however, that we have done this in regard to ~~the union~~; but it is kind of an odd thing. What you want to do is not have people off the job, and here you are giving them rewards in putting them off the job. So there is kind of a disparity in what you are trying to achieve. We are struggling with it.

Senator PACKWOOD. Chuck.

Senator GRASSLEY. I suppose I ought to add lots of questions, but it seems like the hour that I have been here when I have heard you two ask questions of other panels as well as this one, I'm afraid I might plow old ground. They have not been bashful about contacting me on this subject, I don't think I will bedraggle the problem anymore or the issue anymore. [Laughter.]

Senator PACKWOOD. It is exactly that kind of balance that makes you so popular on this committee. [Laughter.]

Gentlemen, thank you very much.

We will conclude today with a panel of John Kriebel from the Sun Co., Harry Smith from the Sun Co., R. William Taylor with the American Society of Association Executives, and Virgil H. Hare, with FMC Corp., Chicago, IL.

Gentlemen, you have been very patient. Thank you.

Mr. Kriebel, go right ahead.

STATEMENT BY JOHN W. KRIEBEL, SUN CO. INC., WESTCHESTER, PA

Mr. KRIEBEL. Thank you, Senator.

I am very proud to be here today. As you know, my testimony is very short, and I am going to give you a little rest.

I am 77 years old, retired for 13 years, and I was employed by the Sun Co. at the Marcus Hook Refinery for 46 years. I assure you I will not give you any of the mind-boggling statements that I have heard here this morning.

I compliment you gentlemen for listening to all of this testimony and even questioning some of these people with questions they couldn't answer. My compliments to you.

My first job with Sun was in 1925 as a messenger boy, and I went through a program of foremanship into the personnel department, which I understand today they call Human Resources. I ended up as a supervisor of employee activities and community relations. I set up a program in community relations for the company.

At the time I was hired in 1925 there were no benefits—none at all. The first benefit that the company gave us was a stock purchase plan. We were able to put a percentage of our salaries into the stock plan, and the company contributed something to that. This program was very helpful to me. I was able to educate two sons—one is now a doctor west of Seattle, and the other is a schoolteacher at the Milton Hershey School in Hershey, PA, which you might know as Chocolatetown, USA.

Later on the company got into a program with the Aetna Insurance Co. which was a supplementary program to medicare. This was very helpful to me. For the last 2 years I have been fighting cancer, and I spent the last year at Sloan-Kettering Hospital in New York. You might be interested to know that Monday of this week I had an examination at Sloan-Kettering, and they say I have no more cancer. I am cured. So I will go back in November for another examination.

But the cancer wasn't too bad; my problem was medicare in New York. Now, medicare in New York thinks there is only one place, that's Westchester, NY. But I live in Westchester, PA. So I was getting mail from Westchester, NY, and Westchester, PA. But the post office was very good—they stuck to the ZIP Code and everything came to Westchester.

But this was a complicated program. They got everything fouled up. In fact, I knew a widow who was in the same position as my wife was in these forms. Her husband died and she had these complicated forms—insurance, Social Security—and she finally said, "You know, I kind of wish now he hadn't died." [Laughter.]

But, gentlemen, I think the private sector can administer these programs beautifully. I have these medical programs that I have lived with for many years. They do a wonderful job. And in the private sector you are eyeball to eyeball with the administrator of the program. If you have a problem you can go to them; they know who you are. You are not a number. And it has just been a wonderful experience for me to be with Sun and be retired.

Senator PACKWOOD. Your story reminds me of when John's wife Emma died: Sy came over to see John and went on at some length about how sorry John must feel. After a minute or two, John said, "Well, now, Sy, it wasn't as if she was a blood relation." [Laughter.]

Mr. Smith.

STATEMENT BY HARRY G. SMITH, DIRECTOR, HUMAN RESOURCES SPECIAL PROJECTS, THE SUN CO., INC., RADNOR, PA

Mr. SMITH. We also appreciate the opportunity to be here. We submitted our written testimony to you, and our modesty permits us to tell you it is an absolutely brilliant record of a success story—a success story in the private sector handling comprehensive benefit programs for thousands of employees. And that success story, in my view, could be repeated many times over throughout the Fortune 500 and the Fortune 1000. I am talking heavy industry; I'm talking big industry. I am not talking the few professional associations or organizations that are doing things that get you people up in the air and cause you to do bad things to us; I'm talking about where the bulk, where the millions of American workers are employed.

I don't think I can add to the body of knowledge here today, but I would like to make a couple of observations. I would like to say again that these benefits are for all employees covering the entire spectrum of income; they are not for the highly paid—that is just foolish. I talked to EBRI here in town, and they have some good research for you.

You call these fringe benefits—that, they ain't. We have 35,000 employees over the whole company and in the oil-related activities maybe 15,000, and the other day we looked into the cost there, and we came up with $225 million roughly, and that includes the legally required payments. Further calculation revealed that for every dollar of wages, 50 cents is going into these benefits. That's why I say they are really not "fringe" or "marginal", they are pretty heavy. And we will pay attention to those costs.

Another thought I would like to leave with you is that I sort of view benefits in two tiers. There are those benefits that are just the basic needs of humanity, and there is the other group. Those basic needs are associated with aging, with disability and death and illness, all that kind of thing. There are new ones coming on. I am not so sure but that in a two-income society day care is just as basic as burying somebody, keeping him well, sending him to the hospital.

So we have to be alert to the changes in our society so that we can make adjustments to take care of the problems.

The other set of benefits—the ones I call the others—you know, Congress made some changes in the code, and then we had a whole army of just absolutely brilliant consultants. They can come up with a dazzling array of all kinds of benefits or produce most anything you want, from a yacht, vacation spas, and heaven only knows. I imagine you can even get tickets to the Redskins' games

But the benefits that we feel should be supported by tax incentives are the basic benefits; what you do with the others is up to you.

They say, "Well, they serve a useful social purpose." Well, so does Little League ball, but I really don't see a relationship between that and the employment relationship. So I think—well, one last thought.

We know we have a deficit, and we feel that the benefits community will have to do its part. But we just ask you to show restraint. I am reminded of the farmer who had this beautiful farm and had a peg-leg hog. A stranger driving along said, "I've got to stop in and see about that hog." The farmer kept ducking the issue, and showed him the farm. Finally he said, "You've got to tell me about this peg-leg hog." "Oh," he said, "that's the most marvelous animal in the world." He said, "Last spring it saved my daughter; she fell in the pond, and before I could get there the hog pulled her out. He done several things."

"Well, what I want to know, tell me about the peg-leg." "Well," the farmer says, "when you have an animal that valuable, you don't eat him all at once." [Laughter.]

Don't eat our benefits all at once.

Senator PACKWOOD. Mr. Taylor.

[Mr. Smith's written testimony follows:]

SUN COMPANY, INC. TESTIMONY TO THE SENATE FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
July 26, 27, 30, 1984

We are here today to share with you a description of Sun's Benefit Program so you may fairly assess the efforts of private industry at providing income security.

I. Direct Cost of Benefits

In 1983, Sun Company spent $155,783,000 to provide basic benefits to all regular employees. Additional benefits were provided which resulted in a supplemental expenditure of $80,616,000 for a total benefit expenditure of $236,399,000. For every dollar Sun spent in 1983 on base wages for an employee, another 50¢ was spent to provide benefit coverage.

II. Benefit Program

Sun maintains a carefully designed retirement program which is intended to meet the replacement income needs of its employees. This program is made up of two plans. One is a defined benefit pension plan, the Sun Company, Inc. Retirement Plan, which provides fixed retirement income and serves as the primary source of retirement benefits. The other is a defined contribution plan, which is called "SunCAP". This plan combines a cash or deferred arrangement (401(k)) with a thrift plan feature which together provide for pre-tax employee contributions, the first 5% of which are matched dollar for dollar by employer contributions. Upon termination or retirement, an employee's account balance is available in the form of a lump sum.

Sun Company has responded to the impact of post retirement inflation in the past by periodically granting non-qualified supplemental payments. Recently, this has been addressed by the Optional Retirement Benefit Income Trust ("ORBIT") Program which preserves retirement income by giving participants who retire the option under SunCAP to purchase an annuity from their account balances. The employee pays only a portion of the full cost of the annuity with Sun paying the balance. This provides a total of 15 annual retirement increases.

Other benefits which are provided to all regular employees and retirees include comprehensive medical coverage, life insurance which is payable before or after retirement, and once eligible for early retirement, all employees become eligible for an automatic 25% spouse's pension in case of an employee's death. After retirement, there is an automatic 50% spouse's pension provided.

III. Conclusion

Sun has a very strong benefits program which would be severly eroded if tax incentives, as they are currently designed, did not exist or were limited in the degree of deductibility. Without the current tax incentives, Sun would be less inclined to develop new programs and would likely, over time, modify existing programs that would provide the employees or retirees with a much lower level of benefit.

PJH/DLD1

Mr. Chairman, we welcome the opportunity to testify today concerning the future of employee benefits and economic security.

Throughout the 20th century, the economic security of workers and retirees has been protected by the strong social values of benefit plans in American industry. This has been evidenced by the strong support these programs have given the troubled Social Security programs as well as to Medicare and Medicaid. It is our view that the Social Security system would have disappeared and been replaced by large, inefficient federal welfare programs without these company sponsored benefit plans.

We would like to take a few moments to discuss the reasons for the emergence of employee benefits. Basic employee benefits are designed to help handle many everyday problems which Americans must face. For example, a disability program allows a disabled employee to continue to maintain his or her approximate standard of living while at the same time encouraging rehabilitation and return to work. Medical insurance programs assist employees in meeting their medical expenses, including those of the employee's family and they also promote good health. Death benefit programs protect dependents against loss of income in the event of an employee's premature death, and retirement plans help to handle the problems associated with aging by providing for the continuation of a reasonable portion of an employee's income in the event of retirement after a career of active service. Unfortunately, neither our most sophisticated technologies, nor our vast government have been able to eradicate or effectively deal with these problems.

Benefit programs are designed to protect all income level employees from the blue collar worker to the executive. These programs also protect the long service employee as well as the employee with very little service. In other words, these programs protect all employees.

The Employee Benefit Research Institute has stated that the economic security constituency for employee benefits is made up of over 150 million participants and beneficiaries. We feel that a constituency so large should lead more elected officials to be concerned about the future of employee benefits.

However, it seems there is a view in Washington that these programs are for the highly paid employees only or that they are viewed as tax-shelters by all involved. This perplexes us since this view is contrary to our own experience. Consequently, we are here to share with you a description of Sun's benefit program so you may fairly assess the efforts of private industry at providing income security.

Direct Cost of Employee Benefits to Sun

In 1983, Sun Company spent $155,783,000 to provide basic benefits to all regular employees. This included expenditures for the following benefits:

Benefits	Expense
Pension Obligations	$51,967,000
Medical Insurance	39,756,000
Legally Mandated Payments	33,661,000
Sun Capital Accumulation Plan (SunCAP)	19,322,000
Long-Term Disability	4,507,000
Death Benefits	4,213,000
Dental Insurance	2,357,000
Total	$155,783,000

Of these dollars, 33.4% was spent for the pension obligations, 25.5% for medical insurance, 21.6% for legally mandated payments, 12.4% for SunCAP and 7.1% for other benefits. Sun also provided additional benefits which resulted in a supplemental expenditure of $80,616,000 for a total benefit expenditure of $236,399,000. For every dollar Sun spent in 1983 on base wages for an employee, another 50¢ was spent to provide benefit coverage.

These amounts are expended to provide Sun's employees with significant levels of economic security. The following discussion describes the specifics of Sun's benefit program and how it provides for our employees' welfare.

I. Retirement Plan

Sun maintains a carefully designed retirement program which is intended to meet the replacement income needs of its employees. This program is made up of two plans. One is a defined benefit pension plan, the Sun Company, Inc. Retirement Plan, which provides fixed retirement income and serves as a typical employee's primary source of retirement benefits. This plan covers all regular hourly and salaried employees and retirees. It provides retirement benefits equal to (1 2/3% times final average earnings times plan service up to 30 years) plus (3/4% times final average earnings times plan service over 30 years) less (1 2/3% times primary social security at age 65 times plan service up to 30 years). Examples of retirement income at various pay levels are as follows:

Employees Retiring 1/1/85 at Age 65 with 30 Years of Service

Final Avg. Pay	Plan Benefit	Social Security	Combined Retirement Income	% of Final Average Pay
$15,000	$ 3,890	$7,222	$11,112	74%
20,000	6,076	7,849	13,925	70%
25,000	8,474	8,055	16,529	66%
40,000	15,843	8,321	24,164	60%

II. Sun Capital Accumulation Plan (SunCAP)

The other part of Sun's retirement program is a defined contribution plan, which is called "SunCAP." This plan combines a cash or deferred arrangement (401(k)) with a thrift plan feature which together provide for pre-tax employee contributions, the first 5% of which are matched dollar for dollar by employer contributions. Upon termination or retirement, an employee's account balance is available in the form of a lump sum. More than 80% of all regular eligible employees participate in SunCAP.

III. ORBIT Program

As you know, sustained periods of inflation seriously threaten any retirement program. As in many companies, Sun's Retirement program is linked to pay and, in this way, keeps pace with changes in the standard and cost-of-living which occur during an employee's career. However, this self-adjusting mechanism stops at retirement, leaving retirement income vulnerable to even modest rates of inflation. For example, the income of a Sun worker who retires on a pension of $1,000 per month, assuming an inflation rate of 5% per year, will be worth $783 after five years in real dollars; after 10 years, the individual's pension will be worth only $613.

In the past, Sun responded to the impact of post-retirement inflation by periodically granting non-qualified supplemental payments, payable from its general assets, which increase the basic benefits provided under the retirement plan. Sun granted ten such increases between 1960 and 1983.

Sun subsequently developed the Optional Retirement Benefit Income Trust ("ORBIT") Program which protects retirement income and is designed to augment basic benefits without changing the underlying design of Sun's qualified plans. It is designed to encourage employees to dedicate a portion of their account balances in Sun's Capital Accumulation Program to the purchase of retirement income.

Under Sun's ORBIT program, participants in the Sun Retirement Plan and SunCAP who retire are given an option under SunCAP to purchase an annuity from their accumulated account balances. The employee pays only a portion of the full cost of the annuity with Sun paying the balance. The ORBIT annuity provides, in effect, a total of 15 annual supplemental retirement income increases. Beginning in the second year of retirement and for each of the next 14 years, the annuity pays an increase equal to 3% of the benefits paid in the prior year from both the basic Retirement Plan and ORBIT. This compounds, so that by the 16th year of retirement, the retiree's income has increased by 56% (3% compounded 15 times). At that point, the augmented retirement income remains level for life. The annuity also contains a 50% survivor benefit coupled with a refund feature which preserves the employee's contributions used to meet a portion of the cost of the annuity.

In designing this program, Sun explored various alternatives for protecting retirement income. Our objective was to use tax qualified plans to fund Sun's obligation so that employees would not be in constructive receipt of taxable income prior to actual payment. The use of annuities provides the employee with the assurance that the benefit payments would be fully funded at retirement and that payments would be guaranteed by an insurance company throughout his or her retirement years. At the same time, annuities purchased through tax qualified plans are less expensive than those which could be purchased individually and the distribution of the annuity will not alter the availability of favorable lump sum tax treatment on other cash amounts distributed with the annuity.

Another key consideration was to share the cost of providing adequate retirement income with employees. In the past, supplemental payments were necessarily provided at employer expense. Partly to reduce the cost of the projected benefits, but mostly due to Sun's philosophy that employees should share the cost of inflation protection through savings, the ORBIT program was designed to be funded by matching employer and employee contributions.

Current law also requires an employer to ratably accrue a pension over the course of an employees' participation in the plan. However, it is difficult to encourage an employee to set aside for retirement hard-earned cash thirty years in advance of retirement based on assumptions of what the eventual cost and need might be. Because of this difficulty inherent in advance-funding retirement benefits with employee and employer funds, the program was structured so that the ORBIT annuity could be purchased at retirement, at the employee's option when the employee is more sensitive to his or her retirement needs and the economic environment. The company contribution was provided at that point to persuade the employee to dedicate his or her funds towards the purchase of the supplemental retirement income represented by the ORBIT annuity.

In order to get ORBIT started, a transition period was established to help employees retiring in the years immediately ahead who wouldn't have as much time to save for their share of the cost of the 3% ORBIT benefit. Even though many current employees have been participating in Sun's capital accumulation programs for some time and do have enough accumulated to meet a 50% cost-sharing requirement, the transition period insures that all Sun employees will be able to participate. Thus, in the first year of the program Sun met 90% of the cost and employees paid 10%. This gradual phase-in has planned to last for 10 years, at which point Sun will be paying one-half of the cost of the annuity and the employee the other half.

The following example illustrates how Sun's ORBIT program works:

Frank retired on January 1, 1984 at age 62. His basic retirement benefit is $585 per month. He learns from Sun that an ORBIT annuity would cost $10,498. He pays 15% of the cost - or $1,575 - and Sun pays the other 85%, or $8,923. During his first full year of retirement, Frank receives $585-per-month benefit from the Sun Company, Inc. Retirement Plan (SCIRP) or $7,020 for the year. The following year, that benefit is boosted by 3% or $17.55. Frank would receive this amount in a check from an insurance company, bringing his monthly retirement income from Sun's plans to $602.55. His total annual benefit in that year would increase from $7,020 to $7,231 for an increase of $211. The following chart describes how Frank's benefits grow annually:

Year of Retirement	Total Annual Benefit (SCIRP plus ORBIT)	Annual ORBIT Increase Over SCIRP
1	$ 7,020	--
2	7,231	$ 211
3	7,448	428
4	7,671	651
5	7,901	881
6	8,138	1,118
7	8,382	1,362
8	8,633	1,613
9	8,892	1,872
10	9,159	2,139
11	9,434	2,414
12	9,717	2,697
13	10,009	2,989
14	10,309	3,289
15	10,618	3,598
16 (& thereafter)	10,937	3,917
	Accumulated ORBIT Increase	$29,179

By the time Frank has received all 15 increases, his retirement income from Sun plans has grown to $10,937 annually or $911 per month, and it remains at that level for the rest of his life. When he dies, his surviving spouse receives 50% of the $911 monthly benefit, or $456 a month.

As can be seen from this example, Sun's ORBIT program is intended to benefit employees by: increasing their retirement benefits; guaranteeing the source of those benefits during retirement years; providing flexibility in the approach toward funding the benefit at retirement; and encouraging employees to save for their retirement years.

IV. Medical Programs

Due to high cost of medical care today, few individuals can afford to "go it alone" when they become ill or need expensive surgery. To help meet these financial responsibilities when these events occur, Sun provides a Medical Program for all of its regular employees, as well as retirees and their dependents for life.

Additionally, if an employee dies, Sun will continue coverage for all eligible dependents for six months free of cost. The employee's dependents may continue the coverage beyond this time by making any necessary employee contributions. Coverage may continue for a period equal to the employee's years of completed company service.

The type of medical coverage which Sun provides is what industry calls "comprehensive" medical coverage. It has no lifetime maximum benefit, provides coverage for a wide range of health care treatment and places a limit on out-of-pocket medical expenses which the employee would have to pay in one year.

An example of how this program specifically works is as follows:

Example

Suppose John, an employee should be hospitalized after suffering a heart attack. Upon discharge, he convalesces at home for six weeks. This example shows what his bills would have been and what benefits he would have received under Plan III. (Assume John has not incurred any covered medical expenses this year.)

type of service	bills	expenses covered by Plan III Comprehensive Coverage (no deductible)	$150 deductible
ambulance to clinic	$ 40		$ 40
emergency medical care (outpatient hospital)	300		300
emergency doctor's care	150		150
hospital room and board, 15 days at $300 per day	4,500	$ 4,050	450
hospital miscellaneous expenses	8,000	7,200	800
surgery	1,000		1,000
consultation	200		200
special nurses	900		900
doctor's visits at home	200		200
outpatient drugs	250		250
outpatient hospital tests	900		900
totals	$16,440	$11,250	$5,190

Plan III would pay:

Benefits payable with no deductible	$11,250
Of the $5,190 in expenses subject to the $150 deductible, John would pay 75% of the balance	3,780
The remaining expenses of $1,410 exceed the out-of-pocket limit on employee medical expenses ($1,000), so the Plan pays expenses above the limit in full, so $1,410 - $1,000 =	410
For a total benefit of	$15,440
So, of the total bills of	$16,440
Plan III would have paid	$15,440
John would have paid	$ 1,000

Sun also provides dental coverage to all active employees.

In conclusion, Sun is very concerned about the rapid escalation in the cost of medical goods and services in this country and has taken numerous steps towards cost containment and the effective management of such plans. These have included accomplishments as developing a Health Maintenance Organization in the Philadelphia area, implementing a comprehensive medical plan as a lower cost option for active employees, and beginning a nurse consultant program which conducts utilization review and monitors the cost and quality of medical care provided.

V. Death Benefits

Sun Company also provides all regular employees with life insurance which is payable to a beneficiary in the event of an employee's death before or after retirement. The Plan offers non-contributory life insurance equal to one times base compensation up to a maximum of $50,000 and supplemental insurance up to three times compensation so an employee may choose the type of coverage which best suits his/her needs. The Company pays the cost of the non-contributory coverage under the Plan.

In addition to Sun's Death Benefit Program is an automatic 25% spouse's pension in case of an employee's death. This coverage is provided for all active employees once they become eligible for early retirement. The cost is satisfied totally by Sun. The employee may also elect an additional 25% spouse's pension which is financed through a reduced benefit at retirement or for the spouse upon the employee's death prior to retirement. After retirement there is an automatic 50% spouse's pension provided which is company paid.

VI. Additional Benefits

Sun also makes contributions to its Payroll Employee Stock Ownership Plan for every regular employee and like most employers provides benefits for time not worked such as up to six weeks vacation; educational assistance which provides all regular employees with 90% of the cost of any approved course of a recognized educational institution to further his/her career; a scholarship plan whereby children, of active, deceased or retired employees may compete for scholarship assistance; and a matching gift plan whereby Sun matches the amount of a personal gift of money or securities that an employee or retired employee contributes to a domestic educational institution. Sun also provides an amount equal to the employee's personal contribution to a qualified community organization.

Conclusion

As you can see, Sun has a very strong benefits program which would be severely eroded if tax incentives as they currently are designed did not exist or were limited in the degree of deductibility.

Benefits such as post-retirement medical and life insurance would most likely be the first to be curtailed if significant funding or deductibility restrictions were placed on such benefits. Plans such as the educational assistance, scholarship support, and matching gift plans would likely be the next to be eliminated. Finally the medical and life insurance coverages for active employees of all salary levels would be reduced to coincide with any future limitations.

Company support for pension plans would be reviewed carefully in light of any congressional amendments which affect pension plans. One can expect over the long run that amendments which make retirement plans more expensive or to deny advanced funding of future pension obligations such as the current freeze on cost of living adjustments to the maximum limitations on contributions to qualified plans* will force us to ultimately reduce retirement benefits by decreasing the amount employees receive as a percent of final average earnings. Sun would also not be inclined to provide funds which create indexed pension benefits for retirees through our current ORBIT Plan.

Suns retirement and welfare programs are designed to provide financial security and independence for employees. To the extent these incentives are "rolled-backed" by Congress, this financial independence must be replaced by dependence on the public systems which are far more inefficient and costly than the programs described herein. Exhibit A demonstrates the lump sum value of these programs reduced to a multiple of final pay measured at retirement.

* Sun drafted testimony as of July 28, 1983 on behalf of the Association of Private Pension and Welfare Plans which demonstrated the impact of a permanent freeze under such limits. Under even reasonable assumptions such a freeze reduces current funding for a retiree who earns as little as $13,000.

In conclusion without the current tax incentives Sun would be less inclined to develop new programs and would likely over time to modify existing programs that would provide the employees or retirees with a much lower level of benefit.

CB1040

7/24/84

EXHIBIT A

INCOME REPLACEMENT AT AGE 65 PROVIDED BY VARIOUS SUN CO. RETIREMENT PROGRAMS AND SOCIAL SECURITY

Program	Percent of Income Replaced by Employer Provided Portion	Percent of Income Replaced by Employee Provided Portion	Total Percent of Income Replaced
SCIRP	265%	--	265%
ORBIT	37%	6%	43%
SUNCAP	150%	150%	300%
Postretirement Medical	58%	2%	60%
Postretirement Life Insurance	9%	1%	10%
	519%	159%	678%

Note: Benefits shown above are based on a sample employee age 65 now with final earnings of $25,000 who entered the plan at age 35. It was assumed that SUNCAP had been in existence for at least 30 years.

STATEMENT BY R. WILLIAM TAYLOR, PRESIDENT, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES, WASHINGTON, DC

Mr. TAYLOR. Thank you, Senator Packwood.

I am William Taylor, president of the American Society of Association Executives. We are an organization of about 11,000 individuals who serve more than 6,000 national, State, and local tax-exempt associations. These associations represent an underlying force of about 55 million people who are the members of these organizations.

Many associations sponsor retirement, health, or other welfare plans as a service to their members. The members who most frequently participate in such plans are small employers or individuals. Our response to your six questions are as follows:

First, the tax law should encourage employers to provide fringe benefits. Tax incentives are essential to the success and stability of the current system of employer-provided employee benefits. Since ASAE's members are individual association executives, the tax incentives of primary importance to ASAE are the ones that result in tax-preferred status at the employee level.

The benefits which ASAE members are most interested in are retirement benefits on a qualified and nonqualified basis, health care, life insurance, disability benefits, day care, educational assistance plans. These basic benefits, in our view, should not generate taxable income for employees.

Second, we oppose the targeting of the fringe benefit area for revision simply to raise revenues. Tax incentives in the fringe benefit area are necessary and should be designed with the singular goal of encouraging the types and levels of benefits that the Congress and the public believe is in the national interest.

Third, ASAE believes the existing rules concerning employee benefits are sufficient to ensure that all employees benefit fairly from the tax incentives. Speaking for our members, under existing rules concerning fringe benefits ASAE members provide a high level of coverage for all employees. Approximately 83 percent of the population covered by private health insurance are through employer group plans.

Fourth, the existing tax incentives for benefits such as health care, life insurance, day care, educational assistance, are effective in encouraging employers to provide these benefits for a broad cross-section of employees at a lower cost than any other approach.

If ASAE and its members did not provide sponsored welfare benefits and education programs, many of these benefits would otherwise be unavailable to individuals or to small employers, or their costs would be prohibitive. The only way these benefits become readily available is on a group purchase basis, frequently requiring involvement of all employees.

Fifth, tax laws that create an incentive to provide certain fringe benefits encourage employers to modify their plans to utilize the tax benefits. It is critical that the tax laws remain relatively constant, because of the cost of implementation and the time it takes to revise such programs, particularly in associations.

Six, ASAE members are particularly sensitive to the tax incentives for employer-provided fringe benefits because these incentives affect their ability to attract well-qualified personnel. Because most associations are small employers, they are concerned about tax incentives that pay the large employers or create tax disadvantages for small employers.

Thank you, sir.

Senator PACKWOOD. Thank you.

Mr. Hare.

[Mr. R. William Taylor's written testimony follows:]

TESTIMONY OF

R. WILLIAM TAYLOR

ON BEHALF OF THE

AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

BEFORE THE

SUBCOMMITTEE ON TAXATION AND

DEBT MANAGEMENT OF

THE SENATE COMMITTEE ON FINANCE

July 27, 1984

I

PRELIMINARY STATEMENT

I am R. William Taylor, President, American Society of Association Executives (ASAE). I am submitting this statement on ASAE's behalf before this Subcommittee that is currently considering viewpoints on tax policy issues concerning fringe benefits.

ASAE is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. ASAE members also include individuals and organizations that serve the association community. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of over 10,000 individuals representing more than 6,000 national, state and local associations. In turn, these business, professional, educational, technical and industrial associations represent an underlying force of more than 55 million people throughout the world. ASAE is dedicated to enhancing the professionalism of association executives, to improving the performance of the voluntary membership organizations they represent and to assisting these executives and their organizations in dealing effectively with public policy issues and in servicing the broad needs of society.

ASAE is almost overwhelmingly made up of representatives of tax-exempt associations. Most of these organizations are either tax exempt under Internal Revenue Code (Code) Section 501(c)(3) or 501(c)(6). An association is tax exempt under Code Section 501(c)(3) if, among other things, it is "organized and operated exclusively for...charitable,... or educational purposes." An organization is tax exempt under Code Section 501(c)(6) if, among other things, it is a "[b]usiness league,...not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual." Over 90% of these tax-exempt associations are structured in the corporate form.

Many associations also sponsor retirement, health or other welfare programs as a service to their members. The members which most frequently participate in these programs are small employers or individuals. The large employers already have the "buying power" to purchase these employee benefits competitively.

As a representative of tax-exempt associations, ASAE represents a unique constituency. ASAE's members are vitally interested in fringe benefit issues. As a not-for-profit organization, a tax-exempt association must look soley to employee benefits to supplement salaries and provide employees with adequate retirement income and other employee benefits. These programs are necessary to allow for the purchase of health and retirement benefits on a group basis to achieve some cost savings.

Accordingly, ASAE is an interested party at this hearing in its capacity both as a spokesman for tax-exempt associations as employers and as a representative of the benefit programs maintained by ASAE's members for their members, whether they be employers or individuals. As an interested party, we appreciate the opportunity to testify before the Subcommittee and to submit our views in writing. What follows is a list of the six (6) tax policy issues raised by the Subcommittee in its Press Release No. 84-148, dated June 4, 1984, and our responses to those issues.

II

TAX POLICY ISSUES

(1) Should the tax law encourage employers to provide fringe benefits; and if so, which benefits or services should be encouraged and what type and level of tax incentive is appropriate?

The tax law should encourage employers to provide fringe benefits. Employers should be encouraged to provide their employees with certain basic employee benefits such as health care and life insurance. As an incentive to do so, the tax laws provide in certain cases tax deductions for employers and non-taxable income for employees. ASAE believes these tax incentives are essential to the success and stability of the current system of employer provided employee benefits.

The tax incentives of primary importance to ASAE on behalf of the employees of associations are the ones that result in tax preferred status at the employee level. This is because ASAE primarily represents organizations that are exempt from taxation under Code Section 501(c). Therefore, although tax deductions are important to for-profit organizations, this is not an issue for ASAE's tax-exempt members. The tax-exempt associations represented by ASAE serve public interest goals. Indeed, that is the basis for their tax exemption under Code Sections 501(c)(3), (c)(6) or other subsections of Code Section 501(c). Their purpose is not to make a profit. Because tax-exempt organizations are different in kind from for-profit organizations, their special needs should be considered in preparing future legislation.

Tax benefits at the employee level are critical to ASAE members because they relieve them of the obligation to pay for both the benefits and the taxes that would be paid by employees on the benefits. In particular, the benefits which ASAE's members are most interested in are retirement benefits on a qualified and non-qualified basis, health care, life insurance, disability benefits, day care and educational assistance plans. These basic benefits should not, in our view, generate taxable income for employees. These benefits are fundamental to the continued harmonious daily existence of employees. Without this protection, individuals are more likely to become destitute and dependent on government-provided benefits. The free-enterprise system must encourage the private sector to provide necessary employee benefits to workers by virtue of adequate tax incentives to ensure the stability and growth of the American economic system.

(2) What conditions or restrictions are appropriate on tax incentives to encourage employers to provide fringe benefits?

ASAE does not have a specific position on what conditions or restrictions on tax incentives are appropriate to encourage employers to provide fringe benefits. ASAE believes, however, that the existing rules have created a system for delivery of employee benefits that is working smoothly and efficiently. A major factor in the success of the current system is the tax incentives under current law.

Unfortunately, it appears that raising tax revenues has become an important if not guiding motivation in recent employee benefit legislation. This trend, if allowed to continue, can only serve to jeopardize the sophisticated and efficient delivery system for benefits that presently exists. To tamper with the status quo is to endanger the needs of workers who have come to rely on their employer provided benefits. ASAE recognizes that it is appropriate to examine periodically existing tax incentives to insure that the system is working properly. We welcome further discussion of these issues, and additional legislation to cure unintended defects and consider whether new and innovative types of benefits such as dependent care should be encouraged through the tax laws. However, the need for legislation to cure defects must be tempered by the need for stability in the law in this area. We oppose regarding the fringe benefit area as ripe for revision simply to raise revenues. Tax incentives in the fringe benefit area are necessary and should be designed with the singular goal of encouraging the types and level of benefits that the Congress and the public believe to be in the national interest.

(3) Are the existing rules concerning fringe benefits sufficient to ensure that all employees benefit fairly from the tax incentives?

ASAE believes the existing rules concerning employee benefits are sufficient to ensure that all employees benefit fairly from the tax incentives. Speaking for our members, under the existing rules concerning fringe benefits, ASAE members provide a high level of coverage to all employees. In this regard, we are attaching to this testimony the portion of the ASAE's 1983 Association Executive Compensation study concerning fringe benefits. Further, the Employee Benefit Research Institute in its 1984 publication entitled "Employer-Provided Health Benefits" has set forth significant figures in support of its conclusion that employer group health plans are the major source of private health insurance coverage in this country. These figures show 83 percent of the population covered by private health insurance in 1979 were covered by an employer group plan.

(4) Are the existing tax incentives for benefits such as health care, life insurance, day care, educational assistance, and cafeteria plans effective in encouraging employers to provide these benefits to a broad cross-section of employees at a lower total cost than if the Government provided the benefits directly, if employers provided the benefits on a taxable basis, or employees purchased these benefits on their own?

The existing tax incentives for benefits such as health care, life insurance and day care are effective in encouraging employers to provide these benefits to a broad cross-section of employees at a lower total cost than if the government provided the benefits directly, if employers provided the benefits on a taxable basis or if the employees purchased these benefits on their own. (Since the legislation authorizing educational assistance programs under Section 127 of the Code expired on December 31, 1983, this testimony refers to the tax incentives that were provided under that Code Section.) ASAE and its members are active in providing association sponsored welfare benefits and education programs for association members. ASAE's experience shows that many of these benefits would otherwise be unavailable to individuals or to small employers or their cost would be prohibitive. The only way that those benefits become available to individuals and small employers is on a group purchase basis.

One efficient way to provide benefits on a group basis is through the use of a Voluntary Employee Beneficiary Association, commonly referred to as a VEBA. VEBAs enjoy a tax-exempt status under Section 501(c)(9) of the Code. Congress has just legislated limits on the reserves that can be accumulated on a tax-free or tax-deferred basis. This creates the ability to accumulate reserves on a tax-exempt basis, thus allowing more money to be spent on benefits. However, the IRS has issued regulations under Section 501(c)(9) that are being applied in a manner which denies a tax exemption to organizations representing employees of related employers operating in more than one state under the concept of "geographic locale," including employee beneficiary associations established by national trade associations. The regulations require that membership in an employee association be defined by reference to objective standards constituting an employment-related common bond among the individual participants. The IRS' position is that multistate and national multiemployer associations do not qualify for tax exemption under Section 501 (c)(9). This will result in the VEBAs of these associations being subject to taxation. ASAE strongly opposes the application of this "geographic locale" concept by IRS. IRS' position is without support in the law or its legislative history. Although we recognize that IRS has in the past expressed concern about the receipt of tax-exempt income by associations from welfare programs sponsored by associations for their members and has used its regulatory authority to attack perceived abuses in this area, this concern should be satisfied through the IRS' latitude to find that an association has unrelated business income and the new limits on reserves under the Tax Reform Act of 1984. Therefore, any perceived abuses may be controlled through existing law without denying tax-exempt status to a multi-state or national association under the geographic locale standard. On this point, we ask Congress for clarification that this result was unintended and, if necessary, for legislation.

ASAE believes that the total cost to society is lower for employer-provided benefits than government-provided benefits because the private sector is generally more efficient and, therefore, able to provide "cheaper" benefits. Further, even if this were not the case, the public sector should provide benefits only if there is no other source of similar benefits.

(5) <u>How will tax laws that encourage employers to provide fringe benefits affect compensation planning?</u>

Tax laws that create an incentive for employers to provide certain fringe benefits affect compensation planning by encouraging employers to modify their plans to utilize the tax benefits. It is critical that the tax laws remain relatively constant because the implementation of most benefit programs takes an extensive period of time. Also, many employee benefit programs provide long-term benefits such as retirement benefits, disability benefits, life insurance or health care. Therefore, regular changes in tax incentives lead employers to resist establishing new programs and to abandon existing programs. In addition, each time the law is changed large amounts of time and large sums of money are spent by the association community and others to comply with changes in the law. Often, these changes are merely technical in nature and do not make any meaningful substantive changes.

(6) <u>Will tax incentives for employer-provided fringe benefits affect potential employees' choice of employment?</u>

ASAE's members are particularly sensitive to the tax incentives for employer-provided fringe benefits because these incentives affect their ability to attract well-qualified personnel. Industry and associations frequently compete within the same labor pool for individuals who have developed the necessary technical expertise and sensitivity from the industry the association represents. These individuals may come from an employer large enough to afford a comprehensive benefit package even in the absence of tax incentives. Because many associations that are members of ASAE are small employers, they are concerned about tax incentives that favor large employers or create tax disadvantages for small employers because they create an often insurmountable handicap in attracting employees. The importance of employer-provided fringe benefits to potential employees, particularly ones looking to change jobs after acquiring family responsibilities, should not be underestimated.

III

CONCLUSION

ASAE is pleased to be a part of the ongoing dialogue concerning the role of the tax laws in the employee benefit area. We represent a large, well-informed constituency that is extremely intererted in this and other employee benefit issues. We welcome the opportunity to assist the Congress by providing the much needed information it needs to analyze the effectiveness of the current tax law and to consider the need for future changes. We are available to collect and provide you with the information you need to make informed well-reasoned decisions concerning tax-exempt associations and employee benefit programs sponsored by associations for their members. ASAE will continue to communicate with its membership to advise it of the status of Congress' deliberations on this and other issues of interest.

Attachment

1983 Association Executive Compensation Study

Compiled by
Priestland Associates
Alexandria, Virginia

Published by the
American Society
of Association Executives
1575 Eye Street, N.W.
Washington, D.C. 20005

Section III

Personnel Practices and Fringe Benefits

Observations

The changes in distribution of answers to questions asked in both 1981 and 1983 surveys are attributable at least in part to whatever changes there were in the make-up of the sample. The relationships among associations of various scopes and among the listed alternative responses are similar for both surveys.

Questions new to this survey give additional information to association executives. There is a cash bonus system in less than one-fifth of the reporting associations. Bonuses are based on many criteria, including the following: merit, association budget surplus, performance in department activities, increasing membership, excess of association revenue over annual goal, and others. Bonuses are paid according to various formulae: "in kind," e.g., spouse travel or car allowance; salary levels; and as a means of recognizing good performance after the top of the salary range has been reached.

There were a few changes in the retirement questions in the current survey. Employer cost of the retirement program was broken out to show the cost as a percent of total association payroll and a percent of the payroll of employees covered. There are no clear patterns in these responses among associations by scope of membership. Cost-of-living adjustments for retirees were defined in this survey as "automatic," "ad hoc," or "none." Over two-thirds of the responding associations make no cost-of-living increases for retirees.

In an effort to present the information on medical insurance in a more comprehensive format, we have presented all positive responses without regard to whether coverage was for single plan, family plan, or both. Often, whether or not a person reported the type of plan available depended on marital status. Hospital indemnity insurance was added to the list of medical insurance coverage this year.

A new question on base salary for an entry level clerk was added to this survey. There were only slight variations in the averages and medians, regardless of association characteristics.

Entry Level Clerk—Base Salary

	# of Responses	Average	Median
By Type			
Trade Associations	525	$10,500	$10,000
Professional Societies	433	10,200	10,000
By Budget			
$200,000 or under	141	10,400	10,000
$200,001–300,000	115	9,800	10,000
$300,001–500,000	154	10,300	10,000
$500,001–750,000	121	10,400	10,000
$750,001–1,000,000	86	10,500	10,000
$1,000,001–2,500,000	193	10,600	10,400
$2,500,001–5,000,000	83	10,300	10,000
$5,000,001–10,000,000	41	10,100	10,000
Over $10,000,000	24	10,100	10,000
By Scope			
National	421	10,800	10,500
State/Regional	405	10,100	10,000
Local	132	9,700	9,600
By Area			
New England	38	10,300	10,000
Middle Atlantic	118	10,000	10,000
East North Central	225	10,200	10,000
West North Central	66	9,700	10,000
South Atlantic	248	10,800	11,000
East South Central	41	9,000	9,000
West South Central	67	10,400	10,000
Mountain	53	9,800	9,600
Pacific	102	11,000	10,800

TABLE 36 Personnel Practices

Analysis of Salary Administration Policies by Association Scope
Position: All Management Personnel

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Established Salary Structure for Management Personnel:								
Total Respondents	1,129	100%	476	100%	494	100%	159	100%
Salary Grades								
Yes	171	15%	96	20%	59	12%	16	10%
No	877	78%	346	73%	399	81%	132	83%
No Answer	81	7%	34	7%	36	7%	11	7%
Salary Ranges								
Yes	327	29%	177	37%	114	23%	36	23%
No	731	65%	273	57%	345	70%	113	71%
No Answer	71	6%	26	6%	35	7%	10	6%
Types of Salary Increases								
Merit Increases	887	79%	398	84%	365	74%	124	78%
General (across-the-board) Increases	369	33%	139	29%	178	36%	52	33%
Cost-of-Living Increases	448	40%	179	38%	205	42%	64	40%
Length-of-Service Increases	132	12%	51	11%	50	10%	31	20%
Usual Intervals and Timing of Salary Reviews								
Usual Interval								
6 months	47	4%	15	3%	21	4%	11	7%
12 months	966	85%	418	88%	422	86%	126	79%
Other*	6	1%	1	**	4	1%	1	1%
No set interval	33	3%	11	2%	15	3%	7	4%
No Answer	77	7%	31	7%	32	6%	14	9%
Usual Timing								
Anniversary date	261	23%	143	30%	87	18%	31	19%
January 1	293	26%	106	22%	127	26%	60	38%
Fiscal Year	343	31%	123	26%	182	37%	38	24%
Annual Convention	36	3%	23	5%	13	2%	0	0
Other	49	4%	25	5%	19	4%	5	3%
No Answer	147	13%	56	12%	66	13%	25	16%
Cash Bonus System								
For Chief Paid Executive								
Yes	182	16%	69	15%	74	15%	39	25%
No	924	82%	396	83%	409	83%	119	75%
For Second Highest Paid Executive								
Yes	124	11%	51	11%	51	10%	22	14%
No	808	72%	369	78%	335	68%	104	65%
For Department Head								
Yes	116	10%	51	11%	49	10%	16	10%
No	776	69%	360	76%	319	65%	97	61%

*Timed to coincide with beginning of association's fiscal year or annual convention.
**Less than 1%

48 **TABLE 37** **Personnel Practices**

Analysis of Employment Contracts by Association Scope
Position: Chief Paid Executive, Deputy Chief Paid Executive

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Chief Paid Executive								
Total Respondents	1,129	100%	476	100%	494	100%	159	100%
Type of Contract								
Formal Contract	330	29%	171	36%	122	25%	37	23%
Letter of Agreement	143	13%	71	15%	54	11%	18	11%
Retained by Resolution of the Board	350	31%	128	27%	173	35%	49	31%
Verbal Arrangement Only	297	26%	100	21%	142	29%	55	35%
Other	6	1%	5	1%	1	**	0	0
Term of Contract								
1 Year	90	8%	44	9%	28	6%	18	11%
2 Years	51	5%	26	5%	18	4%	7	4%
3-4 Years	121	11%	69	15%	39	8%	13	8%
5 Years	47	4%	27	6%	16	3%	4	3%
Over 5 Years	7	1%	4	1%	3	1%	0	0
Continuous Contract	37	3%	15	3%	20	4%	2	1%
Deputy Chief Paid Executive								
Total Respondents	812	100%	371	100%	343	100%	98	100%
Type of Contract								
Formal Contract	46	6%	22	6%	18	5%	6	6%
Letter of Agreement	92	11%	52	14%	33	10%	7	7%
Retained by Resolution of the Board	106	13%	47	13%	49	14%	10	10%
Verbal Arrangement Only	551	68%	240	64%	238	69%	73	75%
Other	17	2%	10	3%	5	2%	2	2%
Term of Contract								
1 Year	36	4%	23	6%	9	3%	4	4%
2 Years	5	1%	4	1%	1	**	0	**
3 Years	17	2%	6	2%	8	2%	3	3%
4-5 Years	1	**	1	**	0	**	0	**
Over 5 Years	0	**	0	**	0	**	0	**
Continuous Contract	10	1%	6	2%	4	1%	0	**

**Less than 1%

TABLE 37 Personnel Practices

Continued

Analysis of Employment Contracts by Association Scope
Position: Chief Paid Executive, Deputy Chief Paid Executive

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Contract clause allowing association to terminate before the specified number of years								
Chief Paid Executive								
Yes	251	22%	127	27%	95	19%	29	18%
No	129	11%	71	15%	40	8%	18	11%
Deputy Chief Executive								
Yes	41	3%	20	5%	14	4%	7	7%
No	51	6%	24	6%	22	6%	5	5%
Length of notice to be given								
Chief Paid Executive								
1 month	42	4%	17	4%	16	3%	9	6%
2 months	36	3%	11	2%	19	4%	6	4%
3 months	83	7%	40	8%	34	7%	9	6%
4 months	9	1%	6	1%	3	1%	0	**
6 months	80	7%	52	11%	20	4%	8	5%
9-11 months	1	**	1	**	0	**	0	**
12 months	24	2%	15	3%	9	2%	0	**
Deputy Chief Executive								
1 month	21	3%	8	2%	8	2%	5	5%
2 months	5	1%	2	1%	2	1%	1	1%
3 months	12	1%	8	2%	3	1%	1	1%
4 months	3	**	2	1%	1	**	0	**
6 months	7	1%	5	1%	2	1%	0	**

**Less than 1%

50 **TABLE 38** **Personnel Practices**

Analysis of Employment Experience by Association Scope
Position: Chief Paid Executive, Deputy Chief Paid Executive

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Chief Paid Executive								
Total Respondents	1.129	100%	478	100%	494	100%	159	100%
Number of years in present position								
1*-2	183	16%	92	19%	71	14%	20	13%
3-5	277	25%	114	24%	115	23%	48	30%
6-9	210	19%	80	17%	101	20%	29	18%
10-14	233	21%	98	20%	[illegible]	23%	25	16%
15-19	94	8%	37	8%	43	9%	14	9%
20-29	104	9%	43	9%	43	9%	18	11%
30 or more	13	1%	5	1%	6	1%	2	1%
No Answer	15	1%	9	2%	3	1%	3	2%
Previous Position								
Current Association (different capacity)	222	20%	108	23%	95	19%	19	12%
Another Association	388	34%	155	33%	172	35%	61	38%
Government	104	9%	34	7%	58	12%	12	8%
Military	25	2%	13	3%	7	1%	5	3%
Private Industry	253	22%	103	-22%	108	22%	42	26%
Self-employed Professional	41	4%	16	3%	18	3%	9	6%
Educational Institution	80	7%	39	8%	34	7%	7	4%
Other	12	1%	6	1%	3	1%	3	2%
No Answer	4	**	2	**	1	**	1	1%
Deputy Chief Executive								
Total Respondents	812	100%	371	100%	343	100%	98	100%
Number of years in present position								
1*-2	238	29%	100	27%	109	32%	29	30%
3-5	222	27%	90	24%	101	30%	31	32%
6-9	153	19%	71	19%	65	19%	17	17%
10-14	108	13%	61	16%	36	10%	11	11%
15-19	43	5%	21	6%	16	5%	6	6%
20-29	37	5%	21	6%	14	4%	2	2%
30 or more	3	**	2	1%	1	**	0	0
No Answer	8	1%	5	1%	1	**	2	2%
Previous Position								
Current Association (different capacity)	145	18%	76	20%	54	16%	15	16%
Another Association	141	17%	77	21%	50	15%	14	14%
Government	92	11%	25	7%	58	17%	9	9%
Military	14	2%	4	1%	7	2%	3	3%
Private Industry	281	34%	127	34%	111	32%	43	44%
Self-employed Professional	30	4%	12	3%	14	4%	4	4%
Educational Institution	79	10%	39	11%	35	10%	5	5%
Other	25	3%	11	3%	9	3%	5	5%
No Answer	5	1%	0	**	5	1%	0	**

*Includes less than one year.
**Less than 1%

TABLE 39 Fringe Benefits

Analysis of Retirement Benefits by Association Scope
Position: All Management Personnel

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Total Respondents	1.129	100%	476	100%	494	100%	159	100%
Types of Retirement Plans*								
IRS Qualified Retirement Plan(s)	518	46%	248	52%	210	43%	60	38%
IRS Qual. & Deferred Comp. Plan	80	7%	37	8%	32	6%	11	7%
Deferred Compensation Plan(s)	82	7%	33	7%	38	8%	11	7%
individual Retirement Acct. (IRA)	115	10%	34	7%	58	12%	23	14%
Tax Sheltered Annuity (TSA)	94	8%	52	11%	28	6%	14	9%
Other	60	5%	20	4%	29	6%	11	7%
None (no plan)	195	17%	63	13%	99	20%	33	21%
No Answer	18	2%	8	2%	8	2%	2	1%
Plan is:								
Defined Benefit Plan	347	37%	178	43%	133	34%	36	28%
Defined Contribution Plan	429	46%	179	43%	181	46%	69	55%
No Answer	158	17%	56	14%	81	20%	21	17%
Eligibility								
At age:								
21 and below	35	4%	11	3%	16	4%	8	6%
22-24	47	5%	22	5%	22	6%	3	2%
25	176	19%	98	24%	60	15%	18	14%
26-30	8	1%	6	1%	2	1%	0	**
And/or after:								
1 year's employment	249	27%	128	31%	95	24%	26	21%
2 years' employment	21	2%	9	2%	10	3%	2	2%
3 years' employment	58	6%	25	6%	22	6%	11	9%
4-5 years' employment	23	2%	14	3%	6	2%	3	2%
Vesting								
100% immediate	196	21%	87	21%	73	18%	36	29%
Graded 100% in:								
Less than 10 years	129	14%	57	14%	56	14%	16	13%
10 years	177	19%	91	22%	72	18%	14	11%
11-15 years	97	10%	48	12%	36	9%	13	10%
Cliff vesting: 100% after 10 yrs.	160	17%	66	16%	74	19%	20	16%
Other	13	1%	9	2%	4	1%	0	**
No Answer	358	38%	119	29%	178	45%	61	48%

*Adds to more than 1.129 because of multiple plans.
**Less than 1%

52

TABLE 39
Continued

Fringe Benefits
Analysis of Retirement Benefits by Association Scope
Position: All Management Personnel

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Retirement age								
Normal retirement at:								
Under 62	24	3%	9	2%	12	3%	3	2%
62	16	2%	6	1%	6	2%	4	3%
65	654	70%	318	77%	258	65%	78	62%
70	11	1%	4	1%	5	1%	2	2%
Other ages	2	**	1	**	1	**	0	**
Early retirement at:								
Under 55	14	2%	6	1%	6	2%	2	2%
55	240	26%	132	32%	82	21%	26	21%
60	58	6%	26	6%	28	7%	4	3%
62	83	9%	38	9%	34	9%	11	9%
Other ages	22	2%	8	2%	7	2%	7	6%
Length of Service Requirement								
Maximum Benefit:								
Years of Service								
Under 10	48	5%	21	5%	22	6%	5	4%
10	157	17%	75	18%	67	17%	15	12%
11-15	75	8%	41	10%	28	7%	6	5%
20	53	6%	29	7%	20	5%	4	3%
25	14	2%	8	2%	5	1%	1	1%
Over 25	42	5%	22	5%	17	4%	3	2%
Early Retirement								
Years of Service								
Under 10	45	5%	23	6%	16	4%	6	5%
10	149	16%	80	19%	56	14%	13	10%
11-15	32	3%	19	5%	10	3%	3	2%
Over 15	30	3%	12	3%	16	4%	2	2%
Minimum Benefit								
Years of Service								
5 or less	146	16%	78	19%	54	14%	14	11%
6-10	60	6%	29	7%	26	7%	5	4%
Over 10	6	1%	5	1%	1	**	0	**
Benefit reduction for early retirement								
Yes	438	47%	221	54%	173	44%	44	36%
No	231	25%	93	22%	97	24%	41	32%
No Answer	265	28%	99	24%	125	32%	41	32%
Funding and Payment								
Percent of retirement program cost paid by the association								
50% or less	18	2%	11	3%	5	1%	2	2%
51-99%	52	6%	31	8%	19	5%	2	2%
100%	677	72%	303	73%	287	73%	87	69%

**Less than 1%

TABLE 39 Fringe Benefits
Continued

Analysis of Retirement Benefits by Association Scope
Position: All Management Personnel

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Employer cost of program as % of total association payroll								
3% or less	67	7%	35	8%	19	5%	13	10%
4-5%	86	9%	40	10%	36	9%	10	8%
6-7%	92	10%	48	12%	39	10%	5	4%
8-9%	81	9%	43	10%	32	8%	6	5%
10%	80	9%	30	7%	43	11%	7	6%
11-15%	84	9%	38	9%	33	8%	13	10%
Over 15%	29	3%	14	3%	13	3%	2	2%
Employer cost of program as % of payroll of employees covered								
6% or less	104	11%	47	11%	40	10%	17	13%
7-9%	127	14%	72	17%	44	11%	11	9%
10%	105	11%	47	11%	46	12%	12	10%
11-14%	73	8%	30	7%	31	8%	12	10%
Over 14%	80	9%	41	10%	34	9%	5	4%
Retirement benefit adjusted automatically for cost-of-living increases for retirees	40	4%	19	5%	18	5%	3	2%
Retirement benefit adjusted on an ad hoc basis for cost-of-living increases for retirees	39	4%	17	4%	18	5%	4	3%
No cost-of-living increases are currently made for retirees	644	69%	305	74%	259	66%	80	63%
Retirement benefit integrated with social security benefit								
Yes	326	35%	155	38%	133	33%	38	30%
No	468	50%	211	51%	196	50%	61	48%
No Answer	140	15%	47	11%	66	17%	27	22%
Pre-retirement spouse's benefit								
Yes	190	20%	97	23%	77	19%	16	13%
No	578	62%	255	62%	240	61%	83	66%
No Answer	166	18%	61	15%	78	20%	27	21%
If yes, is it:								
Contributory	15	8%	10	10%	3	4%	2	13%
Funded by the association	159	84%	78	81%	69	90%	12	76%
No Answer	16	8%	9	9%	5	6%	2	13%
Employees can make additional voluntary contributions to the plan								
Yes	455	49%	221	54%	178	45%	56	44%
No	352	38%	150	36%	153	39%	49	39%
No Answer	127	13%	42	10%	64	16%	21	17%

**Less than 1%

39-706 1352

54

TABLE 40 Fringe Benefits

Analysis of Life & Accident Insurance by Association Scope
Position: All Management Personnel

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Total Respondents	1,129	100%	476	100%	494	100%	159	100%
Basic Life Insurance Coverage Yes	967	86%	423	89%	415	84%	129	81%
No	152	13%	46	10%	76	15%	30	19%
No Answer	10	1%	7	1%	3	1%	0	0
Maximum amount Under $50,000	371	38%	141	33%	166	40%	64	50%
$50,000 or above	572	58%	271	64%	239	58%	62	48%
No Answer	24	2%	11	3%	10	2%	3	2%
Schedule is determined by Salary	495	51%	235	56%	206	50%	54	42%
Job classification	220	23%	85	20%	104	25%	31	24%
Both	101	11%	52	12%	39	9%	10	8%
Other	120	12%	43	10%	50	12%	27	21%
No Answer	31	3%	8	2%	16	4%	7	5%
If by salary, amount is Under 2 times salary	310	52%	141	49%	133	54%	36	56%
2 times salary or more	271	45%	135	47%	110	45%	26	41%
No Answer	15	3%	11	4%	2	1%	2	3%
% of premium paid by association 100%	910	94%	395	93%	394	95%	121	94%
Under 100%	27	3%	15	4%	9	2%	3	2%
No Answer	30	3%	13	3%	12	3%	5	4%
Accidental Death and Dismemberment Coverage Yes	822	73%	369	77%	351	71%	102	64%
No	282	25%	93	20%	135	27%	54	34%
No Answer	25	2%	14	3%	8	2%	3	2%
If yes, is it included in life insurance policy Yes	548	67%	251	68%	226	64%	71	70%
No	226	27%	95	26%	107	31%	24	23%
No Answer	48	6%	23	6%	18	5%	7	7%
Maximum coverage is Under $100,000	395	48%	158	43%	182	52%	55	54%
$100,000-$150,000	239	29%	112	30%	100	28%	27	26%
Over $150,000	143	17%	83	23%	44	13%	16	16%
No Answer	45	6%	16	4%	25	7%	4	4%
% of premium paid by association 100%	748	91%	331	90%	325	93%	92	90%
Under 100%	30	4%	13	3%	12	3%	5	5%
No Answer	44	5%	25	7%	14	4%	5	5%
Association provides travel accident coverage Yes	666	59%	327	69%	268	54%	71	45%
No	442	39%	139	29%	218	44%	85	53%
No Answer	21	2%	10	2%	8	2%	3	2%

**Less than 1%

TABLE 41 Fringe Benefits

Analysis of Long-Term Disability Insurance by Association Scope
Position: All Management Personnel

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Total Respondents	1,129	100%	476	100%	494	100%	159	100%
Association provides a long-term disability plan								
Yes	755	67%	334	70%	324	66%	97	61%
No	352	31%	134	28%	158	32%	60	38%
No Answer	22	2%	8	2%	12	2%	2	1%
If yes, after total disability, benefits commence in								
30 days or less	198	26%	69	21%	96	30%	33	34%
60 days	120	16%	52	15%	53	16%	15	15%
90 days	249	33%	107	32%	115	35%	27	28%
Over 90 days	157	21%	92	28%	47	15%	18	19%
Other	14	2%	8	2%	4	1%	2	2%
No Answer	17	2%	6	2%	9	3%	2	2%
Duration of the payments for accidents is								
Less than five years	83	11%	33	10%	31	10%	19	20%
5-10 years	68	9%	25	7%	31	10%	12	12%
Over 10 years	15	2%	2	1%	12	3%	1	1%
To age 65*	357	47%	177	53%	143	44%	37	38%
For life	189	25%	79	24%	90	28%	20	21%
No Answer	43	6%	18	5%	17	5%	8	8%
Duration of the payments for illness is								
Less than five years	93	12%	34	10%	39	12%	20	21%
5-10 years	72	10%	25	7%	32	10%	15	15%
Over 10 years	12	2%	2	1%	9	3%	1	1%
To age 65*	342	45%	177	53%	131	40%	34	35%
For life	137	18%	56	17%	64	20%	17	18%
No Answer	99	13%	40	12%	49	15%	10	10%
Payments are integrated with Social Security								
Yes	335	44%	152	46%	143	44%	40	41%
No	388	52%	168	50%	169	52%	51	53%
No Answer	32	4%	14	4%	12	4%	6	6%
Benefits as % of salary								
Over 60%	213	28%	75	22%	109	34%	29	30%
50%-60%	352	47%	176	53%	133	41%	43	44%
Less than 50%	131	17%	60	18%	58	18%	13	14%
No Answer	59	8%	23	7%	24	7%	12	12%
% of premium paid by association								
100%	701	93%	306	91%	302	93%	93	96%
Less than 100%	36	5%	19	6%	15	5%	2	2%
No Answer	18	2%	9	3%	7	2%	2	2%

*Occasionally reported to age 70.
**Less than 1%

TABLE 42 Fringe Benefits

Analysis of Medical Insurance by Association Scope
Position: All Management Personnel

	Total No. of Assns.	% of Total Assns.	National Assns.	% of National Assns.	State/ Regional Assns.	% of State/ Regional Assns.	Local Assns.	% of Local Assns.
Total Respondents	1,129	100%	476	100%	494	100%	159	100%
Association provides medical insurance								
Yes	1,076	95%	455	96%	474	96%	147	92%
No	49	4%	19	4%	17	3%	12	8%
No Answer	5	1%	2	**	3	1%	0	**
If yes, types of coverage								
Basic Hospitalization/Surgical	856	80%	378	83%	368	78%	110	75%
Major Medical	999	93%	424	93%	442	93%	133	90%
Health Maintenance Organization	134	12%	63	14%	51	11%	20	14%
Direct medical expense payments	118	11%	50	11%	50	11%	18	12%
Dental Insurance	459	43%	215	47%	180	38%	64	44%
Hospital Indemnity Insurance	53	5%	20	4%	28	6%	5	3%
% of total medical insurance cost paid by the association								
Single plan								
100%	608	57%	272	60%	256	54%	80	54%
51%-99%	51	5%	34	7%	15	3%	2	1%
50%	11	1%	7	2%	2	**	2	1%
Below 50%	3	**	2	**	0	**	1	1%
Family plan								
100%	601	56%	227	50%	293	62%	81	55%
51%-99%	109	10%	73	16%	28	6%	8	5%
50%	28	3%	17	4%	8	2%	3	2%
Below 50%	90	8%	41	9%	35	7%	14	10%

**Less than 1%

Summary of July 27, 1984 Testimony of R. William Taylor on Behalf of American Society of Association Executives (ASAE) Before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance on Tax Policy Issues Concerning Fringe Benefits

(1) ASAE believes that it is in the best public interest for employers to provide employees with fringe benefits which protect them against the exigencies of life for which, were they not protected by employer-provided fringe benefits, employees would be dependent on federal or state government social welfare programs. We believe that the tax law should encourage employers to provide fringe benefits, and that employees should enjoy those benefits on a tax-preferred basis, since the provision and the receipt of those benefits both represent responsible action, consistent with public welfare and the growth of the American economy, on the part of the employer and the employee. As a representative of the employees of tax-exempt associations, the tax incentives we are most concerned with are those which provide tax-preferred status at the employee level.

(2) Although ASAE has not been able to develop a consensus on what conditions or restrictions on tax incentives are appropriate to encourage employers to provide fringe benefits, ASAE believes that raising revenue should not be the primary motivation in employee benefit legislation. Tax incentives should be designed based on the appropriate types and level of benefits.

(3) Under the existing rules concerning fringe benefits, ASAE members as compared to employers of a comparable size provide a high level of coverage to all employees.

(4) The existing tax incentives for benefits such as health care, life insurance, day care and educational assistance are effective in encouraging employers to provide these benefits to a broad cross-section of employees at a lower total cost than if the government provided the benefits directly, if employers provided the benefits on a taxable basis or if the employees purchased these benefits on their own. ASAE and its members are active in providing association sponsored retirement and welfare benefit plans for association members. ASAE's experience shows that many of these benefits either are unavailable to individuals or to small employers (except on a group purchase basis) or, are available only on a premium basis.

(5) Tax laws that create an incentive for employers to provide certain fringe benefits affect compensation planning by encouraging employers to modify their plans to utilize the tax benefits. It is critical that the tax laws remain relatively constant because the implementation of most benefit programs takes a long period of time.

(6) ASAE's members are particularly sensitive to the tax incentives for employer provided fringe benefits since many of their employees have technical expertise that can only be acquired at the member level. Many associations that are members of ASAE are small employers and many of the individuals who they need to hire are being employed by large employers that are their members. Therefore, a change in existing laws to create tax disadvantages for small employers to provide benefits to their employees when compared to large employers puts ASAE's members at a disadvantage in attracting employees.

SUMMARY STATEMENT
OF
V. H. HARE
DIRECTOR, COMPENSATION & BENEFITS
FMC CORPORATION
BEFORE THE
SENATE FINANCE SUBCOMMITTEE ON
TAXATION & DEBT MANAGEMENT
JULY 27, 1984

I AM VIRGIL HARE, DIRECTOR OF COMPENSATION AND BENEFITS FOR THE FMC CORPORATION. FMC WELCOMES THE OPPORTUNITY TO SUBMIT A STATEMENT TO THIS COMMITTEE ON THE VALUE OF EMPLOYEE BENEFITS.

EMPLOYEE BENEFIT PROGRAMS TOUCH UPON THE LIVES OF MILLIONS OF EMPLOYEES. THEY RELY ON EMPLOYEE BENEFITS FOR THEMSELVES, THEIR DEPENDENTS AND THEIR BENEFICIARIES. EMPLOYEES HAVE MADE DECISIONS ON SAVINGS, ON HEALTH CARE, ON LIFE INSURANCE, AND HAVE PLANNED FOR THEIR FUTURE, AND FOR THEIR DEPENDENTS' FUTURES THROUGH THE USE OF TAX-FAVORED EMPLOYEE BENEFIT PROGRAMS.

FOR EXAMPLE, THROUGH TAX-FAVORED EMPLOYEE BENEFIT PROGRAMS, FMC:

- PROVIDES RETIREMENT PROGRAMS FOR ITS EMPLOYEES AND THEIR BENEFICIARIES;
- CONTINUES TO PAY THOSE WHO ARE TOTALLY DISABLED;
- MAKES LIFE INSURANCE PAYMENTS TO BENEFICIARIES AFTER THE DEATH OF THE PRIMARY BREADWINNER;
- PAYS THE MEDICAL BILLS OF THOSE WHO ARE ILL, OR WHO ARE ACCIDENT VICTIMS;
- HAS A SAVINGS PLAN SO THAT EMPLOYEES CAN SUPPLEMENT THEIR RETIREMENT PLAN OR SAVE FOR MAJOR EXPENDITURES, SUCH AS A HOUSE OR CHILDREN'S EDUCATION;
- GIVES SHARES OF STOCK TO EMPLOYEES.

THESE BENEFITS MEET OUR EMPLOYEES' BASIC NEED FOR ECONOMIC SECURITY.

FMC RECOGNIZES THAT ALL TAX-FAVORED PROGRAMS MUST BE SCRUTINIZED CAREFULLY TO MAKE SURE THEY MEET THE SOCIAL NEEDS OF THE UNITED STATES. WE URGE YOU IN YOUR DELIBERATIONS TO CAREFULLY CONSIDER THE EFFECT THAT ANY CHANGE WILL HAVE UPON THE MILLIONS OF U.S. EMPLOYEES COVERED BY THESE PROGRAMS.

STATEMENT OF VIRGIL H. HARE, DIRECTOR, BENEFITS AND COMPENSATION, FMC CORP., CHICAGO, IL

Mr. HARE. Thank you, Mr. Chairman.

I am Virgil Hare, director of compensation and benefits for the FMC Corp., which is headquartered in Chicago. We are a major international producer of machinery and chemicals for industry, agriculture, and the U.S. Government. We had 1983 sales of $3.5 billion, and we have 31,000 employees.

We welcome the opportunity to submit a statement to this committee on the value of employee benefits.

We think that Congress was farsighted in enacting legislation creating the incentive for employers to establish various employee-benefit programs. Through the use of tax-favored initiatives the private sector is able to support the general objective of the economic security, health, welfare, and well-being of the U.S. public.

Millions of employees rely on employee benefits for themselves, their dependents, and their beneficiaries. They have made decisions on savings, on health care, on life insurance, and have planned for their future and their dependents' futures through the use of tax-favored employee benefit programs.

I would like to comment briefly on some tax-favored employee benefit programs at FMC. We, of course, have retirement programs for our employees. We have 17,000 retirees and beneficiaries receiving checks each month; $33 million was paid to them last year. The value of their benefits, which is held in trust solely for them, is $538 million.

We continue to pay those who are disabled. We have 230 people on disability. Payments last year were $1.5 million, and we hold $11 million in a disability trust to be used for the benefit of our employees.

We make life insurance payments to beneficiaries after the death of the employee. During the last 12 months we paid out $6.5 million to 713 beneficiaries.

We pay the medical bills of those who are ill, or who are accident victims, after an appropriate deduction for copayments.

We also have a savings plan so that employees can supplement their retirement, save for major expenditures such as a house or their childrens' education; 80 percent of those eligible participate in our plan, and the total value of their plan benefits is now $175 million.

Through the 1975 Tax Reduction Act we provided stock to our employees. The plan value is $9.8 million.

Programs like FMC's serve millions of employees, their beneficiaries and dependents. We think any change in the tax-favored status of these programs would seriously threaten their economic security. Changes to these benefit programs must be taken as seriously as changes to our Social Security system.

Should Congress remove the tax-favored status of employee benefits, it would be highly unlikely that these additional costs would be shared by industry. Likewise, taxing employees on the values of these benefits would result in many employees declining such coverage; and we think that, without doubt, those declining coverage would be the lower paid employees.

We recognize that Congress must look at all tax-favored programs, and scrutinize them carefully. We urge you in your deliberations to carefully consider the effect that any change will have upon the millions of U.S. employees covered by these programs.

Thank you.

Senator PACKWOOD. Thank you, Mr. Hare.

[Mr. Hare's written testimony follows:]

STATEMENT OF V.H. HARE, DIRECTOR, COMPENSATION AND BENEFITS, FMC CORP.

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, GOOD MORNING.

I AM VIRGIL HARE, DIRECTOR OF COMPENSATION AND BENEFITS FOR THE FMC CORPORATION.

THE FMC CORPORATION, HEADQUARTERED IN CHICAGO, IS A MAJOR INTERNATIONAL PRODUCER OF MACHINERY AND CHEMICALS FOR INDUSTRY, AGRICULTURE AND THE GOVERNMENT WITH 1983 SALES OF $3.5 BILLION. WORLDWIDE, THE COMPANY HAS 31,000 ACTIVE EMPLOYEES LOCATED IN 126 MANUFACTURING FACILITIES AND MINES, IN 29 STATES AND IN 15 OTHER NATIONS. ADDITIONALLY, FMC HAS 17,000 RETIREES.

FMC WELCOMES THE OPPORTUNITY TO SUBMIT A STATEMENT TO THIS COMMITTEE ON THE VALUE OF EMPLOYEE BENEFITS.

CONGRESS WAS FARSIGHTED IN ENACTING LEGISLATION CREATING THE INCENTIVE FOR EMPLOYERS TO ESTABLISH VARIOUS EMPLOYEE BENEFIT PROGRAMS. THROUGH THE USE OF TAX-FAVORED INITIATIVES, THE PRIVATE SECTOR IS ABLE TO SUPPORT THE OVERALL OBJECTIVE OF THE ECONOMIC SECURITY, HEALTH, WELFARE AND WELL-BEING OF THE U.S. PUBLIC.

EMPLOYEE BENEFIT PROGRAMS TOUCH UPON THE LIVES OF MILLIONS OF EMPLOYEES. THEY RELY ON EMPLOYEE BENEFITS FOR THEMSELVES, THEIR DEPENDENTS AND THEIR BENEFICIARIES. EMPLOYEES HAVE MADE DECISIONS ON SAVINGS, ON HEALTH CARE, ON LIFE INSURANCE, AND HAVE PLANNED FOR THEIR FUTURE, AND FOR THEIR DEPENDENTS' FUTURES THROUGH THE USE OF TAX-FAVORED EMPLOYEE BENEFIT PROGRAMS.

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- o PAYS THE MEDICAL BILLS OF THOSE WHO ARE ILL, OR WHO ARE ACCIDENT VICTIMS;
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- o GIVES SHARES OF STOCK TO EMPLOYEES.

THESE BENEFITS MEET OUR EMPLOYEES' BASIC NEED FOR ECONOMIC SECURITY.

A BRIEF REVIEW OF FMC'S PROGRAMS CAN PROVIDE THE COMMITTEE WITH A FULLER UNDERSTANDING OF HOW THESE PROGRAMS WORK.

PENSION PLANS. THE FMC CORPORATION MAINTAINS PENSION PLANS FOR ITS EMPLOYEES SO THEY CAN PLAN FOR RETIREMENT RELATIVELY FREE OF FINANCIAL WORRIES, THUS ALLOWING EMPLOYEES WHO HAVE COMPLETED THEIR WORKING LIFE TO ENJOY THEIR RETIREMENT YEARS. BENEFIT PROVISIONS ARE COMPARABLE TO SOCIAL SECURITY BENEFITS IN THAT FULL BENEFITS ARE PAYABLE AT AGE 65, ALTHOUGH EARLY RETIREMENT CAN BE ELECTED AS EARLY AS AGE 55. VARIOUS PLAN PROVISIONS PROVIDE FOR A CONTINUATION OF EMPLOYEE BENEFIT CREDIT DURING PERIODS OF DISABILITY, AND ALSO PAYMENTS TO BENEFICIARIES SHOULD AN EMPLOYEE DIE BEFORE REACHING RETIREMENT AGE.

FMC PAYS FOR THE FULL COST OF ITS PENSION PLANS; NO COST IS BORNE BY THE EMPLOYEE. THE TOTAL VESTED AND NON-VESTED VALUE OF OUR PENSION PLANS IS $538,000,000. WE HAVE 17,000 RETIREES AND BENEFICIARIES RECEIVING PENSION CHECKS EACH MONTH. TOTAL DOLLARS PAID OUT LAST YEAR REACHED $33,000,000. ALL MONIES IN THE PENSION PLAN ARE HELD IN TRUST FOR THE BENEFIT OF EMPLOYEES AND THEIR BENEFICIARIES.

DISABILITY PAYMENTS. FMC HAS A LONG TERM DISABILITY PLAN THAT PROVIDES UP TO 60% OF AN EMPLOYEE'S SALARY UPON PERMANENT AND TOTAL DISABILITY. THERE IS $11,000,000 IN THE DISABILITY TRUST, WHICH IS SOLELY FOR THE BENEFIT OF EMPLOYEES. WE HAVE 230 PEOPLE RECEIVING PAYMENTS. PAYMENTS DURING THE LAST 12 MONTHS TOTALED $1,500,000.

LIFE INSURANCE. FMC'S LIFE INSURANCE PROGRAMS PAY BENEFITS TO BENEFICIARIES UPON THE DEATH OF EMPLOYEES. DURING THE LAST 12 MONTHS, WE PAID-OUT $6,500,000 TO 713 BENEFICIARIES.

HEALTH CARE PLANS. LAST YEAR, FMC SPENT $55,000,000 FOR HEALTH CARE FOR ITS EMPLOYEES. IN ADDITION TO THE NORMAL MEDICAL CARE THAT PAYS FOR DOCTORS AND HOSPITALS, WE ALSO PROVIDE DENTAL AND VISION CARE. EMPLOYEES SHARE IN THE COST OF THEIR HEALTH CARE BY PAYING FOR A PORTION OF THEIR EXPENSES. ALTHOUGH HEALTH CARE COST CONTAINMENT HAS BEEN A MAJOR EFFORT BY FMC, WE CONTINUE TO VIEW THE COST OF THIS PROGRAM AS A MAJOR EMPLOYEE BENEFIT THAT ADDS A SENSE OF ECONOMIC SECURITY TO EMPLOYEES WHO ARE FACED WITH MAJOR ILLNESSES OR WHO ARE VICTIMS OF ACCIDENTS.

SAVINGS PLAN. SINCE 1961, FMC HAS HAD A SAVINGS PLAN, ENTITLED "THRIFT AND STOCK PURCHASE PLAN," THAT ALLOWS EMPLOYEES TO CONTRIBUTE UP TO 10% OF THEIR SALARY WITH FMC MATCHING UP TO 60% OF THE FIRST 5%. OUR EMPLOYEES USE THIS PLAN TO SAVE FOR MAJOR EXPENDITURES SUCH AS PURCHASE OF A HOME, CHILDREN'S EDUCATIONAL EXPENSES, MAJOR EMERGENCIES, OR TO SUPPLEMENT THEIR RETIREMENT AND SOCIAL SECURITY BENEFITS.

IN APRIL OF 1982, WE CHANGED THIS PLAN TO A 401(k) PLAN THAT ALLOWED EMPLOYEE CONTRIBUTIONS TO BE MADE ON A BEFORE-TAX BASIS. THIS CHANGE FURTHER ENCOURAGED PARTICIPATION IN THE SAVINGS PLAN; WE NOW HAVE 80% OF THOSE ELIGIBLE IN THIS PLAN. AS AN EXAMPLE OF THE INCREASE IN SAVINGS CAUSED BY THE CHANGE TO A PRE-TAX BASIS, TOTAL CONTRIBUTIONS IN 1982 WERE $13,700,000 WHILE IN 1984 THEY ROSE TO $29,400,000. THE TOTAL VALUE OF PLAN BENEFITS IS $175,000,000.

THE TAX-FAVORED STATUS OF CONTRIBUTIONS AND OF DISTRIBUTIONS FROM THE PLAN IS A MAJOR REASON EMPLOYEES SAVE. THESE SAVINGS ADD TO THE FUND OF CAPITAL NEEDED FOR ECONOMIC GROWTH IN THE UNITED STATES, WHILE ALSO PROVIDING A MEASURE OF ECONOMIC SECURITY FOR OUR EMPLOYEES AND A SENSE OF WELL-BEING.

EMPLOYEE STOCK OWNERSHIP PLAN. IN 1975, UNDER PROVISIONS OF THE TAX REDUCTION ACT, FMC ESTABLISHED A STOCK OWNERSHIP PLAN THAT PROVIDES FOR DISTRIBUTION OF STOCK TO ITS EMPLOYEES. THE PLAN ALLOWS EMPLOYEES TO SHARE IN THE GROWTH AND PROFITS OF FMC THROUGH THE VALUE OF ITS COMMON STOCK. EACH YEAR, FMC CONTRIBUTES TO THE EMPLOYEE STOCK OWNERSHIP PLAN AN AMOUNT BASED UPON EITHER AN INVESTMENT TAX CREDIT OR A PERCENT OF PAYROLL TAX WHICH IS USED TO BUY FMC STOCK THAT IS THEN CREDITED TO EMPLOYEE ACCOUNTS. AT PRESENT, EMPLOYEES HAVE ACCUMULATED AS MANY AS 24 SHARES OF FMC STOCK FOR A PLAN TOTAL OF $9,800,000.

FMC ALSO PROVIDES EDUCATIONAL ASSISTANCE PAYMENTS TO ITS EMPLOYEES WHO WANT TO FURTHER THEIR EDUCATION. A RECENT CHANGE IN THE TAX LAW HAS MADE THIS BENEFIT LESS VALUABLE TO EMPLOYEES. THESE PAYMENTS SHOULD BE EXEMPT FROM TAXATION BECAUSE THEY ENCOURAGE EMPLOYEES TO UPGRADE THEIR SKILLS, A SOCIALLY DESIRABLE GOAL. FMC THUS URGES THE RETROACTIVE REINSTATEMENT OF THE SECTION 127 EXCLUSION.

BENEFITS AT FMC ARE AVAILABLE TO ALL COVERED EMPLOYEES, WITHOUT REGARD TO SALARY. EMPLOYEES CAN CONTRIBUTE TO THE SAVINGS PLAN, RECEIVE BENEFITS FROM THE EMPLOYEE STOCK OWNERSHIP PLAN AND SHARE IN THE RETIREMENT PLAN.

FMC'S PROGRAMS ARE NOT UNIQUE. PROGRAMS LIKE FMC'S SERVE MILLIONS OF EMPLOYEES, THEIR BENEFICIARIES AND DEPENDENTS THROUGHOUT THE UNITED STATES. ANY CHANGE IN THE TAX-FAVORED STATUS OF THESE PROGRAMS WOULD SERIOUSLY THREATEN THEIR ECONOMIC SECURITY. CHANGES TO THESE BENEFIT PROGRAMS MUST BE TAKEN AS SERIOUSLY AS CHANGES TO OUR SOCIAL SECURITY SYSTEM.

SHOULD CONGRESS REMOVE THE TAX FAVORED STATUS OF EMPLOYEE BENEFITS, IT WOULD BE HIGHLY UNLIKELY THAT THESE ADDITIONAL COSTS WOULD BE SHARED BY INDUSTRY. MOST LIKELY, WOULD BE THE CESSATION OF MANY EMPLOYEE BENEFIT PROGRAMS. ANY SHIFTING OF COST TO THE PRIVATE SECTOR WOULD RENDER THE PRIVATE SECTOR LESS COMPETITIVE WITH OTHER COUNTRIES AND WOULD PLACE US ON AN EVEN MORE UNEQUAL FOOTING WHEN COMPETING IN THE WORLD MARKET PLACE.

LIKEWISE, TAXING EMPLOYEES ON THE VALUE OF NOW TAX-FAVORED BENEFITS WOULD RESULT IN MANY EMPLOYEES DECLINING SUCH COVERAGE. WITHOUT DOUBT, THOSE DECLINING COVERAGE WOULD BE LOWER-PAID EMPLOYEES, THUS TILTING EMPLOYEE BENEFITS IN FAVOR OF THE HIGHER-PAID.

EMPLOYEE BENEFITS DOVETAIL WITH MANY GOVERNMENT PROGRAMS SUCH AS SOCIAL SECURITY, MEDICARE AND DISABILITY PAYMENTS. THEY RELIEVE THE GOVERNMENT OF SUBSTANTIAL ECONOMIC BURDENS. WITHOUT PRIVATE SECTOR PLANS, EMPLOYEES WOULD BE MORE DEPENDENT ON THE FEDERAL GOVERNMENT; AND IT WOULD BE IMPRACTICAL AND COSTLY FOR THESE PLANS TO BE PROVIDED BY THE FEDERAL GOVERNMENT.

FMC RECOGNIZES THAT ALL TAX-FAVORED PROGRAMS MUST BE SCRUTINIZED CAREFULLY TO MAKE SURE THEY MEET THE SOCIAL NEEDS OF THE UNITED STATES. WE URGE YOU IN YOUR DELIBERATIONS TO CAREFULLY CONSIDER THE EFFECT THAT ANY CHANGE WILL HAVE UPON THE MILLIONS OF U.S. EMPLOYEES COVERED BY THESE PROGRAMS.

ON BEHALF OF FMC'S 48,000 ACTIVE AND RETIRED EMPLOYEES, THEIR DEPENDENTS AND BENEFICIARIES, WE THANK MEMBERS OF CONGRESS FOR THEIR PAST SUPPORT OF EMPLOYEE BENEFIT PROGRAMS AND ASK FOR THE CONTINUATION OF THE TAX-FAVORED STATUS OF EMPLOYEE BENEFITS SO THAT FMC MAY CONTINUE TO SUPPORT THE FINANCIAL AND ECONOMIC NEEDS OF ITS EMPLOYEES IN A SOUND AND EFFECTIVE MANNER THAT HELPS US ALL--THE EMPLOYEE, THE COMPANY, AND THE FEDERAL GOVERNMENT.

THANK YOU.

Senator PACKWOOD. Gentlemen, thank you. I have no questions. This has been a very, complete morning. I am not sure there is much more information to be gathered.

David.

Senator DURENBERGER. If I may, I would just say something to Mr. Kriebel.

You have articulated the frustration of the 29 million Americans who have had to deal with an insurance company that is run by 535 people who don't know anything about insurance, and that is the reality of medicare. All you have to do is get elected to the Congress or the Senate and you are then a health insurance expert.

What I for one am trying to do is to get us out of the insurance business. As you know, we are now changing the reimbursement system from the old cost-based system that everybody used to something that makes sense to the providers and puts some incentives, but it is still an insurance system. Yet, we still say we are going to pay so-much for an appendix, and we are going to pay so-much for an interocular lens transplant, and all that sort of thing, and then we have a process to make sure nobody is cheating.

But while we are doing that—Bob mentioned this health plan operation out in Oregon that has been in existence for a long time—we are on another track which will get us out of the insurance business, which in effect is the capitated payment, or "you qualify based on your age and your sex and your previous health condition" and you have a condition that has a cancer, and the average cost of Westchester, PA. And "we entitle you to *x*-number of dollars." And you go into that community and you buy from private health plans that are competing with each other for however many people there are in Westchester County that are over 65, competing for that business. And those plans then go in and leverage the hospitals and the doctors and so forth and help to get you a good deal. It's got a lot of potential.

You know, we can pay these vouchers, if you will, to employers who want to continue their employees on some choice of company health plans. Rather than give it to the individual, just give it to the employer, and keep that continuity going so that we accomplish that similar end.

But we can't do it—and this is addressed to the rest of you—unless you are providing your employees with some choices of health plans. If you aren't providing choices of health plans, not just a self-insured plan or a company plan that has a high-option, a low-option and a something else, but an option to buy from Blue Cross or an HMO or Aetna, or whatever—once you provide those choices as employers in your various communities, then in the community develops all of these health plans. And they start leveraging against the system. And then we can move more quickly out of the insurance business.

But right now the employers in this country become a real key to facilitating that choice, because they are the ones tha have got all the folks out there, and they are the ones that can create this environment that will get us out of the insurance business and help to bring these costs down.

So, from just one Senator's standpoint, that is the direction we are trying to go. And it's why I believe strongly in this relationship we have developed here and in the value of making sure the Tax Code works in the right kind of way, because we have come a long way from 1925 where maybe Montgomery Ward was the only place that had some kind of a program—Sun obviously didn't have it—to today where we've got these fat benefits that pay you to brush your teeth and see the dentist twice a year, and all that sort of thing, that nobody is contributing anything to.

Somewhere in between that is the reality of where we ought to go. And it seems to me that this system of taxing fringe benefits or not taxing them has a whole lot of potential to facilitate the decisions that everybody is making.

So, Bob, I thank you for this opportunity.

Mr. KRIEBEL. I have only one thing there, and I certainly agree with you. This won't take a second.

This week I got a check from medicare in New York for a $2,500 operation I had in February.

Senator PACKWOOD. That's pretty fast. [Laughter.]

Mr. KRIEBEL. It took me 3 months to get medicare to change my address from New York to Westchester. And their payments are at least 3 to 4 months behind schedule. But the doctor's bill always says, "Please pay immediately."

Senator PACKWOOD. Instead, what you want to do is get the Internal Revenue Service to think you live in Westchester, NY. [Laughter.]

We stand adjourned until Monday morning.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

FRINGE BENEFITS

MONDAY, JULY 30, 1984

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Durenberger, Danforth, Chafee, and Mitchell.

Senator PACKWOOD. The committee will come to order, please. This is the third in a series of three hearings on the subject of employee benefits.

The reason these hearings are being held is to establish as complete a record as possible as to who benefits from employee benefits, and whether or not tax incentives are justified. All of the witnesses have been given a list of six questions, many of which have been specifically addressed.

Let me tell you what the hearings in the first 2 days have revealed. One, it's very clear that the bulk of employee benefits go to lower and middle income employees. The numbers of employees above $35,000, above $50,000 a year are relatively de minimis as far as the entire coverage is concerned.

Two, almost all of the witnesses have indicated that they would support continuing the policy of broadening the antidiscrimination provisions except in a few areas where the discrimination is both supported and justified. This would eliminate those few abuses used by small corporations, founded by professionals who find a legal way to contort the tax laws so that the benefits are skewed to a very few employees in upper income brackets. It is those examples which critics often use to cite what is wrong with employee benefit provisions. We can eliminate those loopholes, and those malefactors that take advantage of the tax system. If the tax structure of employee benefits is going to be changed, if henceforth they are going to be broadly taxed, it's very clear that the tax is going to fall heavily on middle and lower income people.

The reason this record is so important, unless I miss my guess, is that we are going to get into the battle about whether or not we are going to have new taxes next year. I often discover that in terms of the taxation of employee benefits, people often will support that even though they don't count that as taxation. But for those who pay it, I don't think they care what the name is. A tax is a tax.

Next year, I expect a wholesale tax on employee benefits—an effort to limit them, an effort to have all compensation by whatever form derived counted as taxable income. The support for that will be divided into two groups. Those who simply want more revenue, period from whatever source derived in order to reduce the deficit. Narrowing the deficit is a legitimate goal. We will get into a battle trying to raise any place from $75 to $100 million and we will strike out in all directions to raise it. Employee benefits will be one thing that will be touched. You will get into a subsidiary argument there as to whether or not benefits are taxed you will actually collect the taxes or would you rather, in essence, destroy the benefits, in which case no taxes would be collected.

The other group that supports eliminating the tax-free nature of employee benefits comes from those who do not think the Tax Code should be used as an incentive for anything; not for home ownership, not for charitable deductions, not for employee benefits. It is a very logically consistent position. It is not held by a broad scope of a broad number of people. The one thing I find that is overlooked is the assumption that if the Tax Code has no incentives, and many of these socially worthwhile benefits are eliminated, that they are simply not going to be offered by anybody, Government or otherwise. I think the flaw in that thinking is that for many of these benefits, whether they are pensions or day care or educational benefits or something else, if they are not offered by employers, there will be a demand for them to be offered by Government. That demand will eventually succeed. We will probably end up with payroll taxes to pay for those benefits, which will be more expensive than if the benefits were offered by the employers. It will be less responsive because tney will be uniform throughout the Nation, and it won't matter what the demography of your work force is. They will be badly managed by civil servants who will be unresponsive to the bulk of the employees' needs. That, seems to me, to be the alternative in considering this subject.

Today, as I have done in the past, I'm going to have to hold the witnesses to very strict time limits. You have all been advised of this. Your entire statement will be in the record. The reason I am doing that is we had 110 requests for testimony on this subject. I, frankly, was surprised that for 3 days the room would be as full as it is. But it has been full every day.

Of the 110, Treasury wanted to testify in opposition to the concept of untaxed employee benefits. But the other 109 witnesses were on the other side. [Laughter]

Senator PACKWOOD. There is no one else, who asked to testify on the same side as the Treasury. So the choice was to pick 15 or 18 witnesses that would be representative of the entire cross-section and let them each speak for 20 or 30 minutes or to take as many of the 110 as we could because many of the requests come from individual companies with excellent plans and good experience. We chose to take 60 or 70 and very seriously limit the time; encourage people to talk on an ad hoc basis and put their statements in the record, but give us as much oral testimony as possible in the limited time that we have. If I seem arbitrary and rap the gavel when you approach your time limit, you must understand the situation we are in.

With that, we will start with Congressman John Erlenborn a colleague with whom I have worked on many, many matters over the years.

John, we are delighted to have you with us this morning.

STATEMENT OF HON. JOHN ERLENBORN, U.S. HOUSE OF REPRESENTATIVES, STATE OF ILLINOIS

Mr. Erlenborn. Thank you, Mr. Chairman. I certainly appreciate your allowing me to testify with regard to the future tax status of employee benefits. You are to be commended for holding these hearings on a subject that affects all Americans and which, I regret noting, has generated more legislative and regulatory activity than it has constructive deliberation and thoughtful intention.

My statement can be brief. It deals only with the need for a sound retirement income security policy, and misconceptions surrounding the tax incentives involved. Among the other witnesses before the subcommittee are representatives of EBRI and NEBI, two well respected private organizations who are better able to provide you with the significant data.

I'm here, Mr. Chairman, to urge a go-slow approach to the tendency of the Department of the Treasury and the Congress in looking for new revenues to attack the provisions of the Internal Revenue Code that encourage various employee benefits, especially those for pension plans. The reality is that cutbacks in these incentives produce comparatively little in the way of revenue, while discouraging proven programs for retirement income security. In other words, I'm suggesting that the beneficial effects of these tax provisions far exceed whatever revenue might be gained by eliminating or reducing tax incentives for retirement savings, whether by employers or individual taxpayers.

A sound retirement income security plan requires a firm foundation, a three-legged stool, if you will, consisting of Social Security benefits and employer-sponsored pension and individual savings. If any one of these legs is eliminated or reduced, the security every American seeks in old age simply will be diminished, and the Government will have to assume a greater financial burden than the revenue that may be lost by providing the needed retirement saving tax incentives in the first place.

We are all aware of how the costs of Social Security and the Federal retirement programs have grown, and how difficult it is to constrain them. We all also are aware of the virtual impossibility of providing complete retirement income security through such tax-supported schemes. There is an indisputable need for private pension plans as part of the complex of benefits to meet the needs of those whose normal income has been lost due to retirement.

Tax incentives have been the genesis of the private pension system and continue to be an important incentive to the creation and maintenance of individual plans. The attacks on these incentives overlook some basic facts. Much of what is called lost revenue is, in fact, deferred revenue, since taxes are paid on the benefits when received. In addition, the capital represented by the assets of these plans is an invaluable resource for our free enterprise capitalistic system. These pension funds provide the capital necessary to finance new businesses or expand older ones, thus, creating jobs and additional tax revenues.

The more than $1 trillion in private pension funds and IRA's represent a significant capital resource.

Finally, Mr. Chairman, we must look beyond our intentions to the effect of our actions. ERISA, as well intentioned as it was, in fact, precipitated the termination of thousands of defined benefit pension plans. No one knows how many plans failed to be established because of this law. The attack on pension tax incentives often seems to be based on the assumption that benefits go mainly to the rich. TEFRA, with its top heavy rules, was aimed at the owners and the highly compensated employees of businesses. The effect in too many cases was to remove the incentive to initiate or maintain a pension plan, and the average employee was the victim. The highly compensated could find other tax shelters. Thus, the intended victim was not the real victim.

Tax and pension laws are two of the most complex and interactive laws with which we have to deal. My plea to you, Mr. Chairman, is that we move cautiously in making changes in these laws, and not be stampeded by populace arguments that the well to do are benefiting from them. They certainly do, but the average worker also benefits when the incentives lead to actions that enhance all workers' retirement income security as well as providing the capital to create jobs.

There is an urgent need, Mr. Chairman, to get our Federal budget under control. Deficits of $200 billion a year jeopardize our economy. We can cut that deficit, however, without jeopardizing the retirement security of lower and middle income taxpayers.

Again, thank you for allowing me to testify. There are a few other things I mentioned in my prepared text, but in the interest of time I have skipped over those.

Let me make one additional comment, however. The frequent changes that we have been making, mostly in tax laws, in recent years also have a very negative effect on our pension plans. Since ERISA, it has been required by law that all pension plans be required to be maintained pursuant to a written document. Every time we change our tax laws or ERISA in a way that affects pension laws, we require the trustees, the owners of businesses, to go back to their lawyers to have their plans redrafted. Now, as one who is about to go into the employee benefits practice in the private sector, I probably shouldn't be mentioning this, but it seems to me indisputable that many owners of businesses are discouraged from beginning plans or maintaining plans because of the frequent changes and the excessive costs associated with redrafting plans. So I would also plead with you that whatever changes are to be made should be in an omnibus bill, and we ought to have one of those about every 5 or 10 years; no more often.

Thank you, Mr. Chairman.

Senator PACKWOOD. John, it has gotten bad we have a tax reform bill every year now. When you and I first came here we used to have them every 5 or 10 years. Years ago, they were every 20 years. Often we will pass a tax bill and before the IRS has had a chance to draw regulations, we repeal or modify whatever the section was they were drawing the regulations on. I don't blame people for being frustrated.

You mentioned a problem. We try to tighten these and we try to prevent those who are in the upper income brackets from abusing these, and we may inadvertently end up hurting the very people we want to help. That happened in the tax bill we just passed on educational benefits. Eployers could provide educational benefits for their employees without being taxed. We had a 5 year sunset, and it expired the end of last December. That has disappeared. We now go back to the old rule. Te old rule was that the employer could provide educational benefits for the employee if it was related to the employee's job. But if it was to train the employee for a better job, that was taxable income.

Well, the outcome is devastating. There is hardly a person in this room, it would be my guess in looking at the audience, or any corporate vice president for whom education cannot be provided that probably falls within the purview of that person's job, and therefore is not taxable. If you dropped out of high school at either 16 or 17, you are working in the tool crib and you would like to be trained on a computer so you could improve yourself a bit, and the employer is willing to send you to a community college to do that for a cost of $200 or $300 or $400, that's income.

I think that the employer is going to eliminate the educational assistance plan because it is too much paperwork. If the employer has to withhold on every one of those employees and every one of them has to pay taxes, and we are talking about $300 or $400 or $500 a year, the employer just won't do it. It's not going to hurt the vice president of the corporation. He or she will still go off to Harvard for their 2-week training or to the Brookings for their week's program and that will all be paid for and it won't be counted as income. But the person who gets hurt is the lower level employee.

Mr. ERLENBORN. I think you are absolutely right, Mr. Chairman. We have to look beyond the rhetoric, the populous arguments, and look at the real effects.

Senator PACKWOOD. John, thank you very much for coming here.

Mr. ERLENBORN. Thank you.

Senator PACKWOOD. Now we will move onto a panel of Dallas Salisbury, Lance Tane, and Eugene Kalwarski.

Mr. Salisbury, I might say that your organization has perhaps provided more continual solid research in this field than almost any other group. There is a lot of good specific research and a lot of good evidence from individual companies, but your particular association has just been exemplary over the years in the quality of the information we have received.

Mr. SALISBURY. I thank you, Senator.

Senator PACKWOOD. Go right ahead. And your entire statement will be in the record.

Mr. SALISBURY. Fine.

STATEMENT OF DALLAS L. SALISBURY, PRESIDENT OF EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC

Mr. SALISBURY. It's a pleasure to be here. I know you had, as you noted, many witnesses before and will have many more after. I do offer our services, if there are questions and gaps in data, after the hearings where we might undertake specific research projects or other data collection that would help fill this record and the record of future hearings.

As you well know, Senator, employee benefits represent a national commitment to economic security, a social contract, if you will. If we believe in this commitment to helping those help themselves later on and during their working careers, then the first question in the press release must be answered "yes." Tax incentives are appropriate to help provide this economic security net.

A number of issues were mentioned in the other witness' statements that I read this weekend. I think one thing that stands out is most witnesses focused on a balance of cost and benefits. The Treasury statement focused exclusively on costs without regard to economic security considerations.

I think it important to note on the benefit side that health, life and disability benefits today provide for between 90 and 95 percent of all full-time workers in this country. I think it worth noting that retirement programs now provide for over 75 percent of full-time workers, a significant statement of success in response to other questions in the press release that the tax incentives have helped to provide an economic security net across the entire income spectrum, across all sizes of employers.

Second, there are two sides to any issue of tax base erosion, another principal point in the statement of the Treasury. First, I would note that tax expenditure numbers, as is stated clearly in the Federal budget, don't represent what can be gained in absolute dollars by policy change. I note in the Treasury statement they pointed out that one reason changes in the section 415 limits had not raised new revenue is because people had shifted and made use of VEBA's. Therefore, they propose that they cut down VEBA's.

I don't use that as an evidence of what should or should not be done, but simply as a statement that the tax expenditure gain that was claimed in the tax bill of 1982, by the Treasury's own admission, did not occur in 1983. Second, the cost benefit question in the press release. It is important to note that for a $17 billion health care tax expenditure by Treasury estimates over $77 billion in benefits were provided. For a $50 billion tax expenditure for retirement programs, over $87 billion in benefits were provided in that year, a direct implication that direct Government expenditures would have had to have been far higher than the tax expenditures would indicate.

Finally, on that point, I note that out of the over 33 percent of pay that is provided for voluntary employee benefits only 9 percent is currently given tax-favored status; 4 percent is totally tax exempt; the other 5 percent is tax deferred. As you know, our research indicates, as well as the Department of Labor research, that over 70 percent of that deferred tax is eventually regained.

Third, there is a question of equity raised in the Treasury testimony and in the press release between those with employer benefits and those without. Taking health insurance as an example on this equity issue, those without health insurance in 1982 paid taxes at an effective tax rate of between 3 percent and 9 percent. They paid 8 percent of all individual income taxes in this country.

I question, and think that the Congress and the Treasury should seriously question, whether providing "greater equity for this small portion of the taxpaying base" is worth totally disrupting a system which provides such pervasive economic security to over 150 million American workers, their dependents and their beneficiaries.

Fourth, some have implied that employee benefits undermine the Social Security Program. I would point to international experience and the fact that other nations are currently looking very closely at how they can duplicate our employer provision, to compliment those programs. I point to an article in this morning's Wall Street Journal, that I suggest be in the hearing record for this hearing, that points to the tremendous age growth of the population. It asks one question—can we afford the very old? It, in the third page, makes a clear statement: "People are going to need an enormous increase in their assets to maintain their standard of living for so many additional years."

I think private employee benefits, employer sponsored, provide the promise of that.

Finally, Mr. Chairman, in conclusion, I would note as you did, taxation of benefits would clearly lead to loss of coverage for many. It would put increased spending pressure on the Government, on Social Security, on medicare, on medicaid, and multiple other programs. And, it could well lead to age discrimination and age taxation problems. All of these factors need to be carefully considered before action is taken.

[The prepared written statement and the Wall Street Journal article from Mr. Salisbury follow:]

EBRI

T-31

A Statement On

EMPLOYEE BENEFITS AND ECONOMIC SECURITY

By
Dallas L. Salisbury*

Before the United States Senate Finance Committee
Subcommittee on Taxation and Debt Management
Hearing On

Employee Fringe Benefits
July 26, 27, and 30

*The views expressed in this statement are solely those of the author and should not be attributed to the Employee Benefit Research Institute, its officers, trustees, sponsors, or other staff.

Dallas Salisbury is President of the Employee Benefit Research Institute, a non-profit, non-partisan, public policy research organization. Before joining EBRI he served in senior career policy research positions at the U.S Department of Labor and the U.S. Pension Benefit Guaranty Corporation.

07/20/84

EMPLOYEE BENEFIT RESEARCH INSTITUTE
2121 K Street, NW/Suite 860/Washington, DC 20037/Telephone (202) 659-0670

I. Introduction

Employee benefits have a long history in the United States as part of a national commitment to providing a base of economic security to active workers, displaced and disabled workers, retirees, and their dependants and survivors. Most American workers have come to take the presence of social and employer provided employee benefits for granted, viewing them as representative of a social contract: including the current tax treatment of primary employer provided benefits.

- Plymouth Colony settlers decreed the first recorded military retirement program in 1636.
- Gallatin Glassworks established the first recorded profit sharing plan in 1794.
- American Express Company established the first recorded private employer pension plan in 1875.
- Montgomery Ward Company established the first recorded group health, life, and accident insurance program in 1910.
- Baylor University Hospital introduced the first recorded formalized prepaid group hospitalization plan in 1929.
- Congress established the basic retirement income portion of Social Security in 1935 and the Medicare portion in 1965.

The tax treatment of these employee benefit programs has been relatively consistent over time, with health insurance being tax exempt and retirement and capital accumulation programs being tax deferred. Nearly the entire generation of current American workers have experienced the present tax treatment of primary benefits for their entire careers. The law has changed over time to include nondiscrimination requirements such that benefits now generally accrue to all workers, and minimum standards for retirement, capital accumulation and welfare programs ensure that benefit promises are kept.

The total number of plans, assets, and benefit commitments had grown to such a point by the late 1970s that the need for dedicated research activity in the employee benefits area was recognized. In 1978 the Employee Benefit Research Institute (EBRI) was formed as a non-profit, non-partisan, public policy research organization to conduct research and educational programs. EBRI is by charter committed to the premise that the nation is served positively in both social and economic terms by the existence of employee benefit programs: they can be clearly shown to improve economic security. We are aware, however, that there may be limits to what can and should be provided for both social and economic reasons. EBRI undertakes to provide the studies and the statistics that will allow informed priority decisions to be made based upon assessment of documented costs and benefits.

To design efficient long-run public policy, the growth, costs, benefits provided, and the definition of tax-favored employee benefits must be evaluated in a broad context. It is important that policy makers understand the different roles played by the various types of employee benefits--both the traditional benefits like pensions and health, and the newer forms of benefits like Section 401(k) salary reduction and new delivery approaches like Section 125 flexible compensation plans.

This testimony reviews some of the basic questions of concern to Congress and to those interested in the future of employee benefits and the economic security they provide to over 150 million Americans: what are employee benefits; why do we have employee benefits; how much do they cost?; what social and economic objectives do they serve; how have they evolved, where are they going, and what is the role of the tax code; what is the experience of other nations; how much do they cost employers and employees; how much do they cost the Treasury; and what costs might accompany major policy changes.

II. What Are Employee Benefits?

Employee benefits represent virtually any form of compensation that is provided in a form other than direct wages, paid for in whole or in part by the employer, even if provided by a third party. Generally, media articles, cost surveys, and reports lump all benefits together. For policy assessment purposes this should not be done. Different benefits serve different social and economic needs. For legislative policy assessment purposes benefits can be classified into at least nine categories:

1. legally required benefits (including employer contributions to Social Security, Medicare, unemployment insurance and workers' compensation insurance);

2. discretionary benefits that are fully taxable (primarily, payment for time not worked);

3. discretionary benefits that insure the employee against financial risks and are tax exempt (including employer contributions to health, life, and disability insurance plans);

4. discretionary benefits that help the employee meet special needs and are tax exempt (including employer contributions to child care and legal plans);

5. discretionary benefits that have traditionally been called fringes and are intended to meet employer needs and are tax exempt (including employer provision of purchase discounts, job site cafeterias, special bonuses and awards, van pools, clubs, and parking);

6. discretionary "reimbursement account" benefit programs that have been legally allowed since 1978 which allow employees to have reimbursement accounts--funded by the employer or through salary reduction--to pay expenses that fall into "statutory benefit" areas and are tax exempt (including health care reimbursement, child care reimbursement, etc.);

7. discretionary benefits that provide retirement income as a stream of payments and for which taxes are deferred until benefits are received (including employer contributions to defined benefit pension plans and to defined contribution plans which require payment in the form of an annuity);

8. discretionary benefits that provide for the deferral of salary until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, to money purchase plans and ESOPs); and

9. discretionary benefits that provide for the deferral of salary until special needs arise (loans and hardship), or until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, thrift-savings plans, and salary reduction plans).

During a time when there are no apparent limits on direct federal expenditures, or on "tax incentives," analysis may not need to focus on the diversity of employee benefits. During a time of apparent limitations, however, when priorities must be decided upon, careful analysis is required of each employee benefit: why each employee benefit exists.

III. Why Do We Have Employee Benefits?

The Congress, public and private sector employers, and public and private sector employee representatives, have historically shown concern for the welfare of workers, their dependents, and their eventual survivors. This concern has taken the form of both social consciousness and paternalism. It has created an effective social contract between the government, employers, and American workers and their dependents and survivors.

The list of specific values of employee benefit programs that motivate benefit provision can be found in numerous books, with most industrialized nations responding to them, and nations such as Japan now striving to establish employer based programs to complement social employee benefit programs. A formal employee benefit program can meet needs arising from death, disability, medical problems, or the desire to retire, in a fair, consistent, efficient, and certain way.

The nation benefits from employee benefits in many ways:

- morale is improved if workers and their families are relieved of worry and fear over possible financial disaster from unexpected or unplanned for events. Retirement, for example, may be unplanned for in the sense that the individual will not have saved sufficiently to be able to afford retirement.

- Social Security retirement, employer based pensions that pay lifetime benefits, employer based pensions that provide for capital accumulation, and Individual Retirement Accounts, have all been established to avoid this problem while seeking to meet the national goal of allowing retirees to maintain pre-retirement life styles. Experience in this country and in other nations has shown that this "organized" savings effort is essential, particularly at low and middle income levels.

- Social Security disability, Medicare, Medicaid, employer based health, life, and disability insurance programs have been established to protect the working, the non-working, and the retired against financial disaster.

- The nation achieves work force objectives through the provision of employer based employee benefit programs. Because workers are economically able to retire, channels for promotion are kept open; voluntary early retirements can be encouraged with employer based programs if bad economic times require work force reductions; productivity and work quality are enhanced, and thus competitiveness, by strengthening worker identification with the success of the company through employer based profit sharing programs, employee stock ownership programs, and stock purchase programs.

- The nation achieves social stability and popular support for social programs that favor the poor and those with the lowest incomes through income redistribution, by allowing middle- and upper-income workers to build upon the basic level of support the social programs provide them, with employer based tax-favored employee benefit programs. Including, for example, health insurance for <u>both</u> active workers and retirees.

International experience has also shown that a combination of social and employer based programs is the most efficient and effective way to meet economic security needs and objectives.

As pay-as-you-go social programs such as Social Security and Medicare age, and as the "return on contributions" continues to drop, popular support will be very important. The popular support will be present, even if additional changes are made to reduce social program benefits to middle- and upper-income groups--beyond benefit taxation and higher retirement ages--if employer based benefits are available.

Employer based benefits have now been a part of the work place for the entire working lives of most of those working today for government, unionized private employers, large non-unionized private employers, and many small employers. Employee benefits are viewed by most workers as part of a social contract that should and will not be abrogated--by employers or the government. This attitude is the most likely explanation for survey results indicating that employees today take a good benefit package for granted.

IV. Do Tax Incentives Encourage Employee Benefit Availability?

Expanded employer pension and welfare plans over the past thirty years have significantly improved the income security of current workers and future retirees: this development has been possible due to tax incentives. Employee benefit programs are making a significant dollar contribution to the economic security of workers and retirees: at least partially due to tax treatment. The Social Security retirement program paid over $138 billion in benefits to over 36 million beneficiaries in 1982, over 825,000 employer based pension programs provided coverage to over 50 million workers, and paid over $76 billion in benefits to over 15 million beneficiaries in that year (Table 1). Medicare and Medicaid provided $83.3 billion in health protection and private health insurance provided $76.6 billion.

Table 1

Retirement Benefits Paid: 1982

Program	Dollars (Millions)
Social Security	138,800
Employer Pensions	76,891
Federal Pensions	19,211
State/Local Pensions	15,680
Private Pensions	42,000

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, July 1983.

Employer-Provided Pensions

Between 1950 and 1983, the rate of worker participation in employer pensions grew by over 23 percent; in absolute numbers, employee pension participation rose by nearly 300 percent. Econometric estimates suggest that, since 1960, 20 to 30 percent of the increase in employer pension contributions as a share of compensation can be attributed to favorable tax incentives and the growth of real marginal tax rates.

The tax deferral of employer pension contributions and individual retirement saving provides important incentives for employers and workers to provide for retirement income. The increasing importance of pensions as a source of income projected among future retirees is the direct result of past growth in pension plan participation among workers. The projected rate of pension recipiency among today's young workers (ages twenty-five to thirty-four) is nearly twice that of workers who are retiring today (see Table 2 and Figure 1).

Table 2

Estimated Percentages of Families Receiving Pension Benefits at Age Sixty-Five, and Average Real Benefits, by Current Age and Marital Status

	All Families		Married Couples		Single Persons	
Cohort Age in 1979	Percentage to Receive Benefit	Average Amount of Benefit a/	Percentage to Receive Benefit	Average Amount of Benefit a/	Percentage to Receive Benefit	Average Amount of Benefit a/
25-34	71	$12,417	75	$14,541	65	$8,701
35-44	65	11,190	67	12,563	60	8,823
45-54	52	8,656	58	9,621	41	6,496
55-64	37	5,315	44	5,548	26	4,718

SOURCE: Social Security: Perspectives on Preserving the System (Washington, DC: Employee Benefit Research Institute, 1982), p. 90.

a/ Real dollars are calculated using 1982 as the base year.

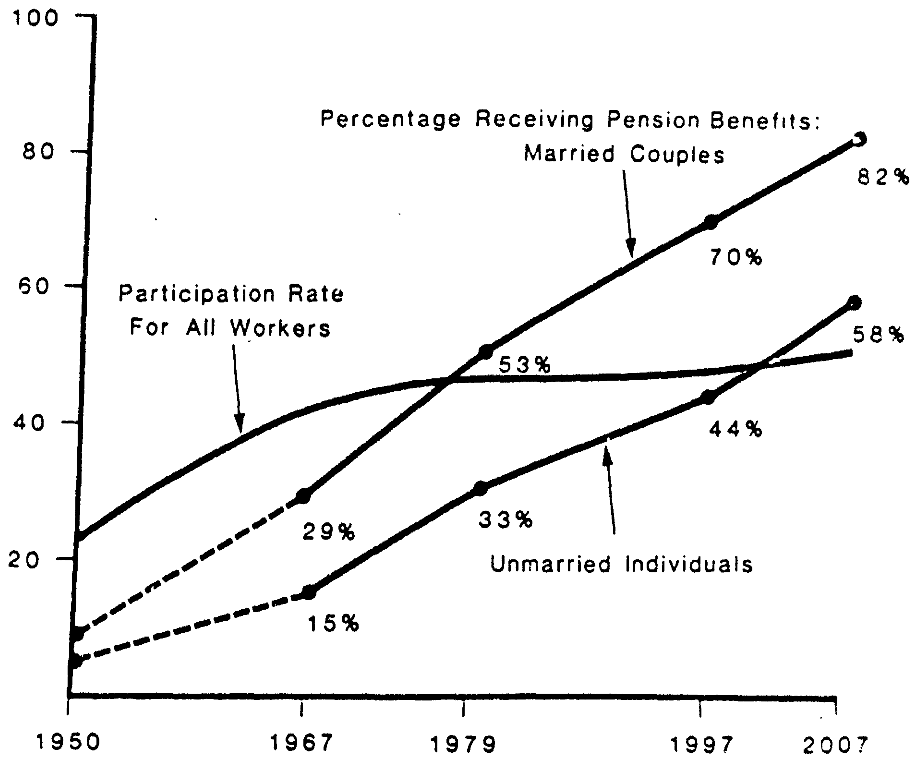
Employer-Provided Health Insurance

Growth of employer group health insurance coverage among workers and their dependents has promoted wide access to health care throughout the population. Health insurance is the most common benefit offered employees in the United States. In 1982, 76 percent of all workers, and 90 percent of full-time full-year workers, reported coverage from an employer group health insurance plan. Most workers (59 percent) have coverage from their own employer plan; however, 22 percent of workers with employer health coverage--17 percent of all workers--have coverage only as the dependent of another covered worker (see Table 3). More than half of all non-workers (52.2 percent, excluding retirees) were covered by an employer group health insurance plan. These persons included primarily non-working adults and children.

Data collected by household and insurer surveys indicate that insurance coverage for major health care expenses, and access to health care services, has risen steadily among the U.S. population since 1960. In 1983, over 66 percent of the nonagricultural wage and salary workers had health insurance coverage from their employers group health plan--nearly 59 million workers. Recent congressional concern over lack of health insurance among unemployed workers and their families suggests that Congress continues to perceive high rates of private health insurance coverage as a public policy goal.

FIGURE I

COMPARISON OF PARTICIPATION RATES FOR ALL WORKERS AND BENEFIT RECEIPT FOR 65-69 YEAR OLDS, 1950-2007



NOTE. The pension plan participation rate is defined as the percentage of all public and private sector workers participating in employer sponsored retirement programs. The rates of benefit receipt are for families containing individuals age 65-69 (for 1997 and 2007, the percentage for families containing a 67 year old). These families include both individuals who work and those that have not worked. The percentage of families receiving benefits includes those eligible for benefits from public and private employer pension programs or Keogh plans. It does not include IRAs.

SOURCE: Estimates of benefit receipt in 1967 from Social Security Administration Demographic and Economic Characteristics of the Aged, 1975. ICF analysis of March 1980 and May 1979 Current Population Survey data for 1979 values. ICF estimates for 1997 and 2007

Table 3

Percent of Workers Covered by an Employer Group Health Insurance Plan by Level of Workforce Activity, 1982 a/

Workforce Activity	Employer Coverage: Total	Employer Coverage: Direct Coverage b/	Employer Coverage: Indirect Coverage b/	No Employer Coverage
Full-time workers	84.1	75.4	8.8	15.9
Full-year	90.0	84.0	6.0	10.0
Part-year	70.0	54.6	15.4	30.0
Part time workers	59.5	18.7	40.8	40.5
Full-year	63.4	27.6	35.8	36.6
Part-year	57.3	13.7	43.6	42.7
All workers	75.9	59.3	16.6	24.1

SOURCE EBRI tabulations of the March 1983 Current Population Survey (U.S. Department of Commerce, Bureau of the Census).

a/ Includes only civilian nonagricultural wage and salary workers; excludes self employed workers and civilian wage and salary workers living in families in which the greatest earner is a member of the Armed Forces or an agricultural worker.

b/ Direct coverage is defined as coverage provided by the worker's own employer plan at any time during 1982; indirect coverage is coverage received as the dependent of another worker in 1982.

The removal of tax preferences for employer health insurance contributions might dramatically reduce rates of coverage among low-income workers and their families, among workers and their dependents who experience unemployment during the year, and among persons who are eligible for Medicaid or Medicare coverage.

An EBRI simulation of the probable pattern of coverage loss suggests that tax preferences for employer health insurance contributions strongly benefit low-income workers and their dependents, provide important economic security for workers with fragmented employment histories, and reduce the public cost of health care entitlement programs.

Tax preferences for employer health and pension contributions and individual saving for retirement are a critical factor in determining worker participation and coverage. Nondiscrimination provisions in the tax code make tax benefits contingent on the breadth of the plan's coverage, that is, both high- and low income workers must be included in tax-qualified plans.

Conclusion: partly because of tax incentives, participation in employer pension and health insurance plans is high. Among full-time, full-year workers, rates of coverage are even higher. In 1983, more than 70 percent of full-time full-year workers were covered by an employer pension plan, and [illegible] percent were covered by an employer health plan.

Appendix I to this testimony presents tables that show the number of workers in each of the fifty States and the District of Columbia covered by employer pension and health programs, IRAs, and 401(k) plans. The tables also present the average incomes of those covered. Three populations are analyzed in these tables: first, the total civilian workforce; second, the "ERISA Workforce," which represents those over age 25, with one year of service, and working over 1000 hours per year; and those over age 35 meeting these criteria. For this last population, 72% are covered by a pension, 83% by a health plan, and 28% have IRAs.

V. Do Tax Incentive Nondiscrimination Criteria Assure Availability at All Earnings Levels?

Employee benefits are widely distributed among workers and their families at all income levels. Reflecting the concentration of workers at low- and middle-incomes, most workers who participate in employer pension and health insurance plans are low- or middle-income workers. In 1983, 76 percent of all wage and salary workers covered by an employer pension plan, and 80 percent of workers covered by an employer group health plan with their employer and reporting earnings, earned less than $25,000 (see Tables 4 and 5).

The distribution of IRA savings among income groups also suggests distribution of IRA tax advantages at every income level (Table 6). In 1982, 18 percent of all IRA accounts, and 14 percent of all IRA contributions, were made by households with adjusted gross income less than $20,000. More than a third of all IRA contributions--34 percent--were made by households with adjusted gross income of less than $30,000. It shows that employer sponsorship does increase utilization, but there is no evidence that tax preferences for employer and employee based employee benefits favor only highly paid workers.

VI. Do Pensions Provide Savings?

Pension coverage constitutes the major source of savings for more than half of current pension participants. While 52.2 million persons, or 56.4 percent of the labor force, had little or no savings of their own in 1979, 26.8 million, or more than half, were covered by employer pensions. Since these persons had incomes just over half the size of those with some savings, pensions appear to distribute wealth more equally than would be the case in their absence. Table 7 shows that federal tax law has been effective in encouraging retirement savings at lower income levels that could not otherwise be expected.

VII. How Much Do Employee Benefits Cost in Total?

Possibly the most often-quoted figures on the level and growth of employee benefits are those compiled by the Chamber of Commerce of the United States.

Table 4

Employment Coverage and Vesting:
Distribution by Earnings for
Nonagricultural Wage and Salary Workers, May 1983

Earnings	Number of Workers (000's)* Employment	Coverage	Total Vested Benefits
Total	80,289	47,372	27,603
$1-4,999	10,014	2,433	358
$5,000-9,999	15,323	5,747	2,023
$10,000-14,999	17,827	10,328	5,484
$15,000-19,999	13,101	9,422	5,874
$20,000-24,999	10,283	8,159	5,641
$25,000-29,999	5,515	4,365	3,048
$30,000-50,000	6,611	5,547	4,072
$50,000 and over	1,615	1,371	1,106

	Percentage Distribution Within Income Group Employment	% Covered to Employed	% Vested to Employed
Total	100.00%	59.00%	34.38%
$1-4,999	100.00	24.29	3.57
$5,000-9,999	100.00	37.51	13.20
$10,000-14,999	100.00	57.93	30.76
$15,000-19,999	100.00	71.92	44.83
$20,000-24,999	100.00	79.34	54.85
$25,000-29,999	100.00	79.14	55.26
$30,000-50,000	100.00	83.91	61.57
$50,000 and over	100.00	84.90	68.50

	Percentage Distribution Across Income Groups % Employment	% of Coverage	% of Total Vesting
Total	100.00%	100.00%	100.00%
$1-4,999	12.47	5.14	1.30
$5,000-9,999	19.08	12.13	7.33
$10,000-14,999	22.20	21.80	19.87
$15,000-19,999	16.32	19.89	21.83
$20,000-24,999	12.81	17.22	20.43
$25,000-29,999	6.87	9.21	11.04
$30,000-50,000	8.23	11.71	14.75
$50,000 and over	2.01	2.89	4.01

*Excludes workers without reported earnings

SOURCE: Employee Benefit Research Institute tabulations of May 1983 EBRI/HHS CPS pension supplement.

Table 5

Distribution of Workers
Covered by an Employer Group Health
Insurance Plan by Personal Earnings, 1982 a/

Personal Earnings	Workers with Employer Coverage b/ (in millions)	Percent of Workers within Earnings Group	Percent of All Workers with Employer Coverage
Loss	1.1	41.2	0.5
$ 1-$ 4,999	29.5	53.3	18.4
5,000- 7,499	10.8	64.6	8.1
7,500- 9,999	9.1	74.1	7.9
10,000- 14,999	19.0	84.7	18.8
15,000- 19,999	14.3	90.0	15.1
20,000- 24,999	10.5	92.5	11.3
25,000- 29,999	6.8	93.6	7.5
30,000- 34,999	4.2	93.0	4.6
35,000- 39,999	2.3	93.0	2.5
40,000- 49,999	2.3	90.8	2.5
50,000- 59,999	1.1	91.1	1.2
60,000- 74,999	0.7	88.3	0.7
75,000 or more	0.9	86.2	0.9
Total, All Workers c/	112.7	75.9	100.0
Summary:			
Loss-$ 9,999	50.5	59.2	34.9
$10,000- 24,999	43.8	88.3	45.2
25,000- 39,999	13.4	93.3	14.6
40,000 or more	5.1	89.7	5.3

SOURCE: Employee Benefit Research Institute tabulations of the March 1983 Current Population Survey (U.S. Department of Commerce, Bureau of the Census).

a/ Includes all nonagricultural civilian workers who reported employer group health insurance coverage at any time during 1982, except workers in families in which the greatest earner is a member of the Armed Forces or an agricultural worker.

b/ Includes coverage from the worker's own employer group plan or from the plan of another worker.

c/ Items may not add to totals because of rounding.

Table 6

Utilization Rates for Voluntary Contribution Retirement Programs, Employer or Self-Provided ERISA Workforce, May 1983

	Employer Deferred Compensation Plan	Employer Provided IRA	Own IRA: Employer Has 401(k) Plan	Own IRA: Employer Does Not Have 401(k)
TOTAL PRIVATE	60.41%	33.02%	31.36%	20.68%
Participants	63.34	33.81	32.42	22.84
Vested Workers	68.64	37.46	37.78	27.24
Noncovered Workers	54.77	37.05	28.56	18.76
Unionized	55.49	22.18	30.37	15.82
Nonunionized	61.98	36.64	31.41	22.04
Size of Firm				
less than 25	62.43	46.38	33.84	22.18
25 to 99	49.23	41.70	25.06	21.13
100 to 499	63.59	35.98	28.91	20.73
500 to 999	58.93	31.26	27.53	21.56
1000 or more	61.85	31.49	34.14	21.38

SOURCE: Employee Benefit Research Institute, preliminary tabulations of May 1983 EBRI/HHS CPS pension supplement.

Table 7

Savings, Pension Coverage, and Income, 1979

Savings Status a/	Covered b/ (in millions)		Not Covered (in millions)		Average Annual Income	
No savings c/	26.8	29.0%	25.4	27.4%	$ 7,672	56.4%
Some savings	25.9	28.0	14.4	15.6	13,914	43.6
Total	52.7	57.0	39.8	43.0	11,193	100.0

SOURCE: Employee Benefit Research Institute calculations based on Bureau of the Census, Current Population Survey (May 1979).

a/ Persons are classified as having some savings or no savings according to whether or not they reported any asset income in the survey. Asset income includes interest, dividends, rents, and royalties.
b/ Coverage refers to employer plans only both in the public and in the private sector and does not include holders of IRA and Keogh accounts.
c/ Includes persons reporting negative asset income.

The figures are based on responses to an annual survey of a small number of employers (fewer than 1,000); the employer sample is not scientifically selected, and it is not weighted to be representative of true national totals. Nevertheless, estimates based on these data capture a picture of the general distribution of employee benefits among: (1) legally required employer payments; (2) fully taxable employee benefits; and (3) tax-favored employee benefits. Disaggregating the total level of employee contributions reported in the Chamber of Commerce data among these three groups clarifies the magnitude of tax-base erosion that can be attributed to the growth of employee benefits.

According to the Chamber of Commerce data, employer contributions to fully taxable, tax-exempt and tax-deferred employee benefits exceeded 32 percent of wages and salaries in 1982. Nearly three-fourths of this figure (23.5 percent of wages and salaries) represented either legally required employer payments (9.5 percent of wages and salaries) or discretionary employer payments (13.9) percent of wages and salaries) that are fully taxable. Legally required employer payments include contributions for Social Security, unemployment compensation insurance, workers' compensation insurance, and a variety of smaller public insurance programs. Discretionary employer contributions to benefits in the Chamber of Commerce data represented 23.0 percent of wages and salaries in 1982. Of this amount, nearly two-thirds (60.4 percent) were fully taxable both by Social Security and by the individual income tax. The fully taxable benefits reported in the Chamber of Commerce data include employer payments for time not worked (paid vacations, holidays, and sick leave) as well as paid rest periods, lunch periods, and other paid employee time not directly spent in production. Less than one-third of the total level of employee benefits reported in the Chamber of Commerce data (27.7 percent) represent discretionary tax-favored benefits paid by employers In 1982, tax-favored benefits totaled 9.0 percent of wages and salaries.

The Size of Tax-Favored Benefits--Employer contributions to tax-favored benefits--those that are not taxed as current income to the employee--can be divided into two groups: benefits on which taxes are deferred and benefits that are tax exempt.

- Tax-deferred benefits include primarily employer contributions to retirement income and capital accumulation plans. These constituted about 4.0 percent of wages and salaries in 1982. Taxation of these benefits is deferred until the employee withdraws funds from the plan.

- Tax-exempt benefits include employer contributions to group health insurance and a variety of smaller benefits that include dental insurance, child care, merchandise discounts, and employer-provided meals. These benefits constituted 4.6 percent of wages and salaries in 1982.

Failure to distinguish among the growth of legally required employer payments, fully taxable employee benefits, tax-deferred benefits, and tax-exempt benefits has greatly distorted the perception of the tax-base erosion that can be attributed to tax-favored and tax-exempt benefits. This common misperception was highlighted by Secretary of the Treasury Donald Regan; his May 22, 1983, statement to ABC News included the following comment:

> "I think that when you look at the way our pension systems our medical systems and the like are...running at full throttle, and are increasing year after year, that sooner or later they're going to have to be slowed down or else we'll never get these deficits under control."

The size of tax-favored benefits as a proportion of wages and salaries, however, is much smaller than such statements suggest. Tables 8 summarizes the distribution of tax-favored benefits by tax-deferred and tax-exempt status.

VIII. How Much Have Tax-Favored Employee Benefit Costs Grown?

Over the past thirty years, tax-favored employee benefits have grown more rapidly than wages and salaries, and slightly faster than either legally required employer payments or fully taxable employee benefits. Consequently, tax-favored benefits have absorbed a rising share of total compensation. In the context of strong and increasing tax incentives for employees to demand a greater share of compensation in the form of tax-deferred or tax-exempt benefits, however, the growth of these benefits as a share of total compensation has been remarkably slow. Additionally, the cost of tax-favored benefits appears to be slowing as employers work to ration scarce resources.

The National Income and Product Accounts data compiled by the Department of Commerce indicate that employer contributions to major tax-favored benefits as

Table 8

Composition of Employee Benefits by Benefit Group, 1982

Benefit Group	Employer Payments as a Percentage of Wages and Salaries	Employer Payments as a Percentage of All Benefits
Total Benefit Payments	32.5	100.0
Legally Required Employer Payments:	9.5	29.2
Social Security (FICA)	5.2	16.0
Unemployment Compensation	1.1	3.4
Workers' Compensation	0.9	2.8
Other Legally Required Payments a/	2.3	7.1
Discretionary Taxable Benefits:	13.9	42.8
Time not worked b/	9 [illegible].	30.2
Rest Periods	3.8	11.7
Other Taxable Benefits c/	0.3	0.9
Discretionary Tax-Favored Benefits:	9.0	27.7
Contributions to pension and Profit-Sharing Plans d/	4.0	12.3
Group Health, Life, Short-Term Disability Insurance	4.4	13.5
Other Tax-Favored Benefits e/	0.6	1.8
Summary:		
Legally Required Employer Payments and Discretionary Taxable Benefits	23.5	72.0
All Discretionary Benefits	23.0	61.5
Fully Taxable Benefits	13.9	42.8
Tax-Favored Benefits	9.0	27.7

SOURCE: EBRI tabulations of estimates produced by the U.S. Chamber of Commerce, Employee Benefits 1982 (1983), pp. 11 and 28.

a/ Includes government employee retirement, Railroad Retirement Tax, Railroad Unemployment and Cash Sickness Insurance, and state sickness benefits insurance.

b/ Includes paid vacations and payments in lieu of vacation; payments for holidays not worked; paid sick leave; payments for State or National Guard duty; jury, witness, and voting pay allowances; and payments for time lost because of death in family or other personal reasons.

c/ EBRI estimate based on Chamber of Commerce report of amount of Christmas or other special bonuses, service awards, suggestions awards, special wage payments ordered by courts, and payments to union stewards.

d/ EBRI estimate of Chamber of Commerce report of employer contributions to profit-sharing plans.

e/ EBRI estimate of Chamber of Commerce report of employer-paid dental premiums, merchandise discounts, employee meals furnished by company, payments for vision care and prescription drugs, moving expenses, and contributions to employee thrift plans and employee education expenditures. Tax-preferred benefits are overstated by the amount of separation or termination pay received by employees but not distinguishable from other tax-favored benefits in the Chamber of Commerce estimates.

a fraction of total compensation increased at an average annual rate of 12.8 percent between 1960 and 1982. The long-term growth of tax-favored benefits relative to total compensation growth is presented in Table 9.

The growth in the early 1970s reflects several factors: the slow growth of wages both before and during economic recession; employer efforts to improve

Table 9

Average Annual Growth Rates of Major Employee
Benefits as a Share of Total Compensation, 1950-1983

Employee Benefit	Average Annual Rate of Growth (in percents) 1950-1980	1970-1980	1980-1983
Total Benefits	2.5	1.8	2.2
Legally Required Benefits	2.6	2.1	3.0
Discretionary Fully Taxable Benefits a/	1.4	1.2	1.2
Discretionary Tax-Favored Benefits	4.4	3.0	3.0
Government Pensions	2.1	0	0
Private Pensions and Profit-Sharing	4.9	4.5	1.9
Group Health	6.3	4.5	6.1
Group Life	2.3	-2.2	0

SOURCE: EBRI calculations based on U.S. Chamber of Commerce, Employee Benefits 1982 (Washington, D.C.: Chamber of Commerce, 1983).

a/ Vacation time and other time not worked. Calculations based on interpolations from Chamber of Commerce data for 1980 and 1982.

pension funding in anticipation of the enactment of the Employee Retirement Income Security Act (ERISA) and in response to ERISA; net growth in pension and health plan participation; and sudden increases in the employer cost of group health insurance benefits. The recent slower growth of employer pension contributions appears to be likely to continue, according to the most recent employer surveys. The slower growth between 1980 and 1982 of employer health insurance contributions as a share of total compensation may reflect the maturation of group health coverage and benefits, as well as employer efforts to contain the cost of private health insurance plans.

Employer contributions to group health insurance are the fastest growing component of employee benefits. The expansion of worker and dependents' coverage under employer group plans, the enhancement of benefits under these plans, and persistent high inflation in health care costs have all contributed to the growth of employer contributions to health insurance as a share of compensation. Between 1950 and 1980, employer health insurance contributions as a percent of total compensation have risen at an average annual rate of 6.3 percent. Reflecting continued high inflation in health care costs since 1980, employer contributions to health insurance have continued to grow at an average annual rate of 6.1 percent more than the growth of compensation.

The growth of employee benefits as a form of employee compensation has attracted increasing attention in recent years chiefly because of a concern that the growth of benefits occurs at the expense of growth in wage and salary income. Slower growth of wages and salaries, in turn, implies slower growth of the tax base. Erosion of the tax base affects the public sector's ability to finance government programs in general and the Social Security system in particular. In addition, growth of nontaxable benefits may generate an important redistribution of the tax burden across the population. These effects of growth in employee benefits, and in tax-exempt benefits in particular, merit careful attention.

IX. <u>How Much Do Costs Vary by employer</u>?

The cost of discretionary employee benefits varies significantly from employer to employer. During 1982 total expense ranged from 12.5 to 29.0 percent of total compensation among Fortune 500 firms, and the expenditure would be lower for very young and small businesses. Table 10, presenting data for the Fortune 500 and for twelve different industry groups, shows that significant variation is also found in industries. Analysis of industry by industry wage and salary levels vary to offset employee benefit cost variation.

X. <u>How Much Do Costs Vary by Employee Age?</u>

Employee benefits such as defined-benefit pensions and health insurance are almost always discussed as a flat dollar cost per employee or as a level percentage of pay per employee. Employee representatives, employees, and employers have been content with this approach since the actual distribution of cost <u>does not</u> affect either the taxes to be paid by the employee or the

Table 10

Low, Average and High Employer Contributions to Discretionary Employee Benefits as a Percent of Total Compensation, 1982

Industrial Classifications 1/	Total Worker Retirement 2/ Low	Avg.	High	Total Worker Insurance Benefits 3/ Low	Avg.	High	Total Retiree Dis. & Health 4/ Low	Avg.	High	Grand Total Low	Avg.	High
Petroleum & Refining	8.6	11.2	13.9	6.9	9.0	11.2	.7	.9	1.1	16.2	21.1	26.2
Electronics (Appliances)	6.0	7.6	9.2	7.2	9.0	10.9	.5	.6	.7	13.8	17.2	20.8
Office Equipment (includes computers)	5.1	6.5	7.7	7.6	9.6	11.3	.6	.7	.8	13.3	16.8	19.8
Industrial and Farm Equipment	7.5	9.7	13.6	7.8	10.1	14.1	.7	.9	1.3	15.9	20.7	29.0
Pharmaceuticals	7.4	8.8	9.8	8.1	9.7	10.8	.8	.9	1.0	16.3	19.4	21.5
Chemicals	10.1	11.6	15.0	8.5	9.8	12.6	.8	.9	1.2	19.4	22.3	28.8
Paper, Fiber and Wood Products	7.5	9.2	10.3	8.0	9.9	11.1	.9	1.1	1.2	16.4	20.2	22.6
Food	8.3	10.0	11.6	8.2	9.9	11.5	.7	.9	1.0	17.3	20.8	24.1
Utilities	7.4	10.1	12.6	6.9	9.5	11.9	1.1	1.5	1.9	15.4	21.1	26.4
Life Insurance	8.1	12.5	15.0	6.0	9.1	11.1	1.0	1.6	2.0	15.1	23.2	28.3
Banks	11.4	13.9	15.0	7.2	8.8	10.0	.7	.8	.9	19.3	23.5	26.8
Retailing	6.0	7.1	7.8	6.2	7.4	8.1	.3	.4	.4	12.5	14.9	16.4
Fortune 500	5.1	9.8	15.0	6.0	9.8	14.1	.3	1.1	2.0	12.5	20.6	29.0

Source: EBRI calculations of data provided by Hewitt Associates.

1/ Based on *Fortune* magazine's industrial classifications.

2/ Total worker retirement includes employer contributions to defined benefit and defined contribution pension plans, and profit sharing plans.

3/ Total worker insurance benefits includes employer outlays to group life and survivor plans, long- and short-term disability plans, and health insurance (including medical, dental and vision plans).

4/ Total retiree disability and health includes employer contributions to health insurance and disability income for retirees.

employer. As a result, the only attention given to date to actual per employee cost variation has been undertaken very recently to assess (1) approaches to health care cost containment and (2) possible disincentives to hiring or keeping on older workers. These recent studies show very significant cost variation by age (Table 11).

Does this cost variation matter as a matter of tax policy? I would suggest that the answer would be yes if employee benefits were to be subjected to income tax or FICA tax. Yet, it is an issue that has been ignored in all analysis undertaken to date. For example, during testimony before this Committee on June 22, 1983, the Administration's witness analyzed the proposed health care tax cap only as an issue of income levels, not of age. When asked by Senator Bentsen if it would not have an age discrimination effect, Assistant Secretary Rubin responded: "No, because those costs are spread over the entire company. So it amounts to somewhat inconsequential in terms of dollars-per-worker over the entire company."

Yet, let us assume that the Bradley-Gephardt "Fair Tax Act" is adopted and these benefits are fully taxable to the employee. Will the young worker be willing to pay tax on an average amount when it is known that the actual cost for him or her is only 70% of that amount and that for an older low paid worker it may be nearly 225% of the average? Will this form of tax "inequity" be allowed to exist? If it does will any young people want health insurance? And, if it doesn't, will older workers be able to afford to have health insurance?

The present approaches to health insurance pricing and delivery were developed in the tax environment that we have today. A major change in that environment will have a major affect on those approaches and structures. Nearly all of the government and academic research done on this subject to date assumes that these factors will in no way change and that human behavior will not change. This assumption is contrary to over seventy years of experience with employee benefits under the tax code.

Does this say that the tax treatment of employee benefits should not be changed? Not necessarily, but it does say that we must do far more--and far more complete--analysis than has generally been done thus far.

XI. Tax Preferences and Federal Revenue Losses: The Concept of Tax Expenditures

Since enactment of the Congressional Budget Act of 1974, the Treasury Department has been required to compile annual estimates of tax expenditures resulting from "exceptions to the normal structure" of the tax code.

Deferred taxation on pension contributions and investment earnings and tax exemption of other employee benefits produces what the law defines to be a tax expenditure. These estimates are important to an employee benefits policy discussion because they are frequently used as estimates of the revenue the government could raise if particular provisions of the law were changed.

Table 11

Summary of Cost Factors by Age for Use in Costing Benefit Plans

Age Group	Medical Cost Factor as % of Average Cost	Defined Benefit Cost Factor as % of Average Cost	Life Insurance Cost as % of Pay for One Times Pay
Under 30	80.0%	23.0%	0.1%
30-34	80.0%	33.0%	0.1%
35-39	80.0%	48.0%	0.2%
40-44	80.0%	69.0%	0.3%
45-49	100.0%	100.0%	0.6%
50-54	112.5%	146.0%	1.0%
55-59	125.0%	216.0%	1.5%
60-64	160.0%	323.0%	2.3%
65-69	225.0%	*	2.3%

SOURCE: The Costs of Employing Older Workers (Washington, DC: U.S. Special Committee on Aging and the Employee Benefit Research Institute, forthcoming).

Note: Same life insurance cost is assumed for 65-69 as for 60-64 because it is assumed that the benefits will be reduced to equal cost; regulations allow a 30% reduction.

If benefits are not reduced, assume costs at 65-69 are about 30% higher.

Defined contribution costs are the same by age.

Pension costs are determined on the basis that retirements are at age 65 or current age is greater.

The government recognizes the shortcomings of these estimates and publishes warnings about the use of tax expenditure numbers:

- Estimates assume no other changes in the tax laws.

- Estimates assume no change in taxpayer behavior if the law is changed--even if this is the only provision changed.

Economists refer to this as "partial equilibrium" analysis. This means that most of the real world is assumed away so that rough estimates are possible. As a result, these estimates suffer as guides to policy. Therefore, they must be used with great care. Analysts cannot, for example, legitimately use the numbers to indicate that elimination of favorable employee benefit tax provisions would produce $X of additional revenue for the fisc or $X for the use of such programs as Social Security, health insurance for the unemployed, or Medicare.

XII. How Much Do Benefit Plans Cost the Treasury?

The total estimate of tax expenditures for employee benefit programs--social and employer sponsored--totaled 91.4 billion dollars in FY 1983. IRAs and plans for the self employed added another 10.3 billion. Appendix II provides a full list of the tax expenditure estimates.

Because of the tax-deferred status of pensions, estimates of how much they cost the Treasury--how big the tax expenditure is--are wide ranging: from $28 billion to $56.9 billion for FY 1983.

The wide variation in these estimates and in year to year OMB estimates can be attributed to the following:

- Frequent changes by Treasury in assumed tax rates.

- Recent changes in the universe of plans included in the estimates.

- Differences in the methodology used to calculate the partial-equilibrium tax expenditure estimates.

As noted, all of the available estimates overstate what could be gained by the fisc if all tax preferences for pensions were eliminated:

- Part of all pension tax expenditure estimates is the deferral of tax on the full value of contributions. Yet, if these amounts were paid as direct compensation, some portion of it might still be sheltered from tax under other code provisions.

- Part of all pension tax expenditure estimates is the deferral of tax on investment earnings. Yet, investment of these funds in tax-exempt municipal bonds would lead to no tax revenue ever, and investments in real estate, equities, or bonds would allow the deferral of tax for very long periods. In fact, if invested in housing, an increasingly large portion might escape tax altogether due to the capital gains exclusion for those over age 55.

- Recent contributions to the literature debate methodology. New methods which use a lifetime estimation approach are better that the traditional cross-section approach. But to be comparable to other tax expenditure categories, these lifetime estimates cannot count future interest on what some have classified as the tax free loan from the Treasury.

Numerous other shortcomings of using tax expenditures as a basis for decision making have been pointed out by various economists, politicians, and actuaries.

Private retirement program tax expenditures form the single largest category of tax expenditures in the federal budget. They arise from the deferral of taxes paid on: (1) pension and retirement saving contributions; and (2) earnings on these contributions. Tax deferral of pension and retirement saving contributions represents deferral of current revenue; taxes are paid on withdrawals from the funds after the worker retires. In a lifetime context, however, gross federal revenue losses are significantly lower than current revenue deferrals. As much as 72 percent of the real (i.e., inflation-adjusted) value of taxes deferred during pension participants' working careers is ultimately repaid in retirement income taxes (Table 12).

Treasury tax expenditure statistics overstate the proportion of current tax deferrals permanently lost to the Treasury. Treasury statistics imply that 83 cents out of every deferred dollar is permanently lost, with the other 17 cents accounted for by current tax payments by retirees. When examined in a lifetime context, the proportion of deferred taxes lost to the Treasury ranges from 14 cents out of every dollar to 40 cents, depending on whether or not one adjusts for inflation and interest on deferred taxes and the interest factor used.

Employer contributions to group health insurance are the fourth largest tax expenditure in the 1985 budget. These contributions are exempt from Social Security, corporate income and individual income taxation.

Tax expenditure estimates are a poor guide for setting either federal tax policy or federal retirement or health policy. Nevertheless, the high tax expenditure estimates for pension and group health insurance plans continue to attract public attention and critical appraisal of these plans' tax-favored status. Measurement of current versus lifetime tax revenue losses, however, is only part of the task of evaluating tax preferences for employer pension contributions, retirement saving, and employer-sponsored health insurance.

Tax laws favoring employer retirement and health insurance plans and statutory provisions for other benefits were enacted under the premise that the broad coverage of workers and their dependents under these plans is desirable social policy. Employment practices have developed surrounding these programs--principally retirement, savings, health, life, and disability--for

Table 12

How Much of Pension-Related Tax Deferrals is Lost to the Treasury?

Method Used	Taxes Lost	Taxes Deferred
Treasury Method	83%	0%
...fetime Method:		
...inal dollars a/	14	86
R... dollars b/	28	72
Dis...ted for interest: c/		
at ...on rate	40	60
at f... l rate	36	64

SOURCE: Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, DC: Employee Benefit Research Institute, forthcoming).

a/ Before adjusting for inflation.
b/ After adjusting for inflation.
c/ Interest rate used to discount taxes paid in retirement to the year of retirement.

decades. Further, workers and their families have come to depend upon them and to expect them. A change in the tax treatment of these programs must be recognized as a fundamental change in the social contracts of our society.

While this does not say change is impossible; it clearly argues for a public and well informed debate. Few of the over [illegible] million Americans who depend on these programs have any awareness that change is even being discussed. And all in the government must recognize that enactment of basic tax reform proposals would include fundamental change in the tax treatment of employee benefits.

XIII. New Forms of Employee Benefits

The growth of new tax-favored employee benefits has come under close scrutiny due to concern that they might represent further erosion of the tax base. In fact, employers often have independent motivations for setting up these plans. The growth of new benefits--in particular, Section 401(k) salary reduction plans and Section 125 cafeteria plans--generally represents an effort by employers to contain the employer cost of tax-favored employee benefits. Introduction of child-care programs is an accommodation to the growing number of working mothers, particularly single heads of households. For the latter group, this benefit may be the only thing that makes working possible. If they couldn't work, a direct public social expenditure would be more likely.

Rising employer pension costs have prompted several innovations in the design of retirement income plans. Section 401(k) plans, authorized by the Revenue Act of 1978, have become an increasingly popular tool for controlling employer pension costs. Employees are able to supplement employer contributions to a Section 401(k) plan with tax-deferred contributions of their own.

This allows employers to contain their retirement plan costs. In general, Section 401(k) plans probably represent a net reduction in employer pension contributions relative to the level that would be required to ensure adequate retirement income with lower employee retirement saving.

Section 401(k) plans also reduce the employer's projected cost of indexing retirement benefits. Although pension benefit increases are seldom automatic, most employers provide *ad hoc* cost-of-living adjustments for current retirees. Under current law, sponsors of defined-benefit pension plans cannot reserve funds against future *ad hoc* cost-of-living increases, even in cases where the plan has a clear history of providing those increases. *Ad hoc* increases, therefore, are funded from current contributions, or offset against actuarial gains, or added to the plan's unfunded liability.

Section 401(k) plans--and other defined contribution plans--represent a way to provide employees with some inflation protection in retirement at substantially lower cost to employers. Defined contribution plans are automatically indexed, since the asset value of the plan generally rises with inflation. Inflation reserves, therefore, accumulate automatically.

Section 401(k) plans also meet the demand for retirement income security among mobile workers and workers with intermittent labor force participation. Employee contributions to Section 401(k) plans are, by law, fully and immediately vested. Short-tenure workers, therefore, may be better served by 401(k) plans than by more traditional plans. These workers, and workers with intermittent labor force participation, are protected because they can "roll over" the accumulated contributions and earnings of the plan into a tax-deferred Individual Retirement Account. As a result, Section 401(k) plans may particularly benefit young workers with high labor-force mobility and women who may leave the labor force for protracted periods.

The growth of cafeteria (or Section 125) plans also reflects employers' efforts to control the cost of employee benefits. Generally, the primary motive of employers in establishing a cafeteria plan is the containment of employer contributions to health insurance and to make workers more sensitive to health costs. "Mature" cafeteria plans can be characterized as those which have broken the automatic link between inflated health care costs and employer support for health insurance coverage. Cafeteria plans encourage employees to elect less generous health insurance coverage and substitute other benefits--both tax-favored and fully taxable benefits--for generous health insurance coverage. Like Section 401(k) plans, cafeteria plans enable employers to meet the benefit needs of an increasingly diverse work force--including young workers and women--while controlling total benefits costs.

Cafeteria plans have emerged and matured despite the fact that regulations were only recently promulgated. Alleged abuses in the design of some cafeteria plans have recently been dramatized. Cafeteria or flexible compensation plans plans may include a reimbursement account or flexible spending account; but broad based plans are not synonymous with, or dependent on, flexible spending accounts. Where the government believes abuses exist, limits or guidelines for the use of benefits within cafeteria plans have been set on at least a proposed basis. Examples of possible abuses within cafeteria plans should not obscure the overall efficiency of these plans and their cost advantages for both employers and employees.

XIV. Revenue Implications of New Forms of Employee Benefits

Many observers of the emerging changes in employee benefit plans have claimed that the development of new forms of employee benefits merely represents further tax-base erosion. These claims, however, have often been made with little or no supporting evidence. There are several reasons to believe that the growth of nontraditional benefits--in particular, Section 401(k) plans and cafeteria plans--may actually reduce further erosion of the payroll and individual income tax bases.

While employer contributions to traditional pension plans are entirely tax deferred, employee contributions to Section 401(k) plans are taxable by Social Security. Employers have favored Section 401(k) plans as a means of reducing the level of contributions they might have to make if they offered only a traditional pension plan. If the growth of Section 401(k) plans does, in fact, substitute for the growth of more traditional pension benefits, they would represent an addition to the current payroll tax base.

The growth of cafeteria plans also implies potential growth of the payroll and income tax bases. Cafeteria plans typically include a menu of taxable and tax-favored benefits. Cafeteria plans encourage employees to elect less generous health insurance coverage, and substitute spending for other benefits--both taxable and tax-favored--for tax-exempt health insurance spending. As a result, these plans do not necessarily represent erosion of the tax base.

XV. Conclusion

Tax laws favoring specific employer retirement and health insurance plans and other statutory employee benefits were enacted under the premise that extensive coverage of workers and their dependents under these plans is desirable social policy. The growth of worker coverage by pensions and health insurance has been strongly encouraged by the tax advantages accorded these plans and by the the needs of workers and their dependants and survivors for economic security.

Analysis of the distribution of coverage and vesting by earnings category indicates that pensions are broadly distributed among lower and middle income workers: 76 percent of all nonagricultural wage and salary earners covered by a pension earn $25,000 a year or less. Similarly, 70 percent of all vested benefits belong to nonagricultural employees earning $25,000 or less.

May 1983 EBRI/HHS survey data also show that women are gaining pension entitlement in greater numbers than ever before. Among those women meeting ERISA standards for plan participation, coverage expanded by 2.2 million workers since 1979 and nearly 1.3 million more women became entitled to pension benefits at retirement.

1983 survey data also shows that the tax law has been successful in spreading health insurance coverage across the income spectrum, with over 80 percent of those with health insurance earning less than $25,000 in 1983.

This government policy success should be a matter of national pride. There are many different types of benefits--each must be carefully evaluated. They must be judged against both social and economic criteria--the costs and the benefits. The favorable tax treatment allowed them may not be crucial to the existence of some benefits--but it is essential to the provision of employee benefits at all income levels.

Other nations now seek to match the success of this nation in developing a true public and private sector partnership in meeting economic security needs. Employee benefits do not cost the Treasury as much as some charge--but evaluation of whether it may be to much is a desirable and legitimate function of the Congress. Were employer-sponsored benefits to disappear, however, one could expect higher rates of elderly poverty, greater demands on social programs, heightened strife among generations, and tens of millions of surprised and disappointed Americans.

APPENDIX I

EMPLOYEE PENSION AND HEALTH PLAN COVERAGE BY STATE

SOURCE: EBRI tabulations of 1983 EBRI/HHS Current Population Survey May Pension Supplement.

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION

	CIVILIAN WORKFORCE	AVERAGE INCOME	PENSION COVERAGE	% COVERED	AVERAGE INCOME
Total	98,963,821	$15,960.27	51,530,197	52.07%	$19,499.17
STATE					
ALABAMA	1,412,800	14,604.37	674,932	47.77	17,904.26
ALASKA	169,352	23,060.26	81,745	48.27	26,994.26
ARIZONA	1,220,314	16,141.70	594,602	48.73	19,706.17
ARKANSAS	892,630	11,562.23	330,421	37.02	14,306.59
CALIFORNIA	10,552,206	18,160.23	5,408,747	51.26	21,965.81
COLORADO	1,461,703	17,061.65	714,540	48.88	21,705.48
CONNECTICUT	1,514,791	18,850.37	881,211	58.17	22,250.68
DELAWARE	277,260	16,710.20	173,691	62.65	19,541.73
DISTRICT OF COLUMBIA	262,714	17,309.46	136,984	52.14	19,247.80
FLORIDA	4,506,621	13,487.39	1,793,325	39.79	16,031.30
GEORGIA	2,432,600	13,829.30	1,176,805	48.37	17,193.57
HAWAII	470,799	16,031.15	257,399	54.67	19,334.15
IDAHO	366,862	15,263.51	184,927	50.41	19,431.39
ILLINOIS	4,867,743	17,600.74	2,706,505	55.60	21,340.21
INDIANA	2,304,353	14,765.10	1,266,161	54.95	17,871.50
IOWA	1,228,463	14,300.88	644,360	52.45	16,929.30
KANSAS	1,049,375	14,713.55	507,713	48.38	17,910.71
KENTUCKY	1,345,239	13,924.41	708,125	52.64	17,178.53
LOUISIANA	1,528,105	14,750.59	673,063	44.05	18,454.00
MAINE	530,634	13,192.55	251,164	47.33	16,221.57
MARYLAND	2,009,061	18,461.43	1,211,853	60.30	21,824.03
MASSACHUSETTS	2,653,150	16,360.66	1,489,831	56.15	18,944.66
MICHIGAN	3,834,430	16,089.10	2,186,700	57.03	19,764.13
MINNESOTA	2,044,271	14,320.60	948,847	46.41	18,175.15
MISSISSIPPI	905,415	14,300.70	463,077	51.15	17,580.60
MISSOURI	2,180,437	14,619.46	1,067,403	48.96	18,384.10
MONTANA	341,499	13,983.09	129,654	37.97	18,329.36
NEBRASKA	705,704	12,567.07	313,802	44.47	15,943.55
NEVADA	465,231	16,656.75	226,453	48.68	20,054.66
NEW HAMPSHIRE	418,775	14,984.99	222,973	53.24	18,460.06
NEW JERSEY	3,321,390	17,770.43	1,833,111	55.19	21,997.13
NEW MEXICO	538,119	15,028.49	252,578	46.94	18,053.40
NEW YORK	7,007,157	16,719.06	4,033,309	57.56	19,916.23
NORTH CAROLINA	2,657,459	13,560.47	1,325,530	49.88	16,600.67
NORTH DAKOTA	273,672	13,694.05	105,164	38.43	18,372.76
OHIO	4,660,579	16,162.00	2,836,462	60.86	19,416.11
OKLAHOMA	1,384,765	15,899.90	529,199	38.22	20,406.19
OREGON	1,212,730	15,787.53	623,292	51.40	19,517.86
PENNSYLVANIA	4,857,542	15,170.87	2,815,101	57.95	17,983.65
RHODE ISLAND	411,074	13,213.83	216,600	52.69	16,162.88
SOUTH CAROLINA	1,350,111	12,063.77	557,461	41.29	15,666.63

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION—Continued

	CIVILIAN WORKFORCE	AVERAGE INCOME	PENSION COVERAGE	% COVERED	AVERAGE INCOME
STATE					
SOUTH DAKOTA........	306,577	$13,324.42	140,708	45.90%	$16,091.66
TENNESSEE...........	1,917,291	16,095.64	1,104,164	57.59	19,933.13
TEXAS...............	6,790,184	17,068.25	3,130,359	46.22	20,709.91
UTAH................	625,403	14,830.72	307,062	49.10	19,041.73
VERMONT.............	232,956	12,807.08	118,869	51.03	15,845.11
VIRGINIA............	2,610,404	16,924.21	1,563,969	59.91	20,143.66
WASHINGTON..........	1,696,329	16,319.99	819,390	48.30	20,892.39
WEST VIRGINIA.......	669,230	13,918.09	378,752	56.59	17,175.54
WISCONSIN...........	2,275,370	14,492.64	1,304,692	57.34	18,593.45
WYOMING.............	211,770	15,701.05	99,234	46.86	20,557.27

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION

	CIVILIAN WORKFORCE	AVERAGE INCOME	TOTAL IRA'S	% WITH IRA'S	AVERAGE INCOME	TOTAL 401K'S	% WITH 401K'S	AVERAGE INCOME
Total..............	98,963,821	$15,960.27	16,712,837	16.89%	$23,346.05	2,703,440	2.73%	$25,036.96
STATE								
ALABAMA............	1,412,800	14,604.37	107,536	7.61	22,279.26	8,537	.60	11,713.00
ALASKA.............	169,352	23,060.26	26,874	15.87	28,945.15	5,829	3.44	31,049.03
ARIZONA............	1,220,314	16,141.70	152,956	12.53	25,260.42	38,530	3.16	26,759.42
ARKANSAS...........	892,630	11,562.23	90,517	10.14	18,703.76	11,490	1.29	22,023.24
CALIFORNIA.........	10,552,206	18,160.23	1,786,270	16.93	25,244.46	331,730	3.14	27,120.62
COLORADO...........	1,461,703	17,061.65	276,187	18.89	23,465.61	44,470	3.04	23,900.26
CONNECTICUT........	1,514,791	18,050.37	295,304	19.49	26,132.23	46,420	3.06	29,661.70
DELAWARE...........	277,260	16,710.20	41,595	15.00	29,856.75	5,043	1.82	29,791.74
DISTRICT OF COLUMBIA	262,714	17,309.46	27,959	10.64	27,457.17	3,573	1.36	28,639.07
FLORIDA............	4,506,621	13,407.39	474,814	10.54	19,254.70	80,017	1.78	22,655.31
GEORGIA............	2,432,600	13,829.38	331,599	13.63	22,021.50	50,976	2.10	18,151.35
HAWAII.............	470,799	16,031.15	75,566	16.05	23,493.51	3,993	.85	19,403.09
IDAHO..............	366,862	15,263.51	67,460	18.39	21,905.92	5,279	1.44	12,616.00
ILLINOIS...........	4,867,743	17,600.74	1,022,473	21.01	23,794.43	194,640	4.00	25,131.31
INDIANA............	2,304,353	14,765.10	344,508	14.95	19,642.00	71,400	3.10	25,294.72
IOWA...............	1,228,463	14,300.80	191,078	15.55	18,595.11	27,345	2.23	23,056.51
KANSAS.............	1,049,375	14,713.55	190,253	18.13	19,652.47	24,674	2.35	23,263.05
KENTUCKY...........	1,345,239	13,924.41	181,877	13.52	21,560.29	16,936	1.26	29,126.96
LOUISIANA..........	1,528,105	14,750.59	174,551	11.42	18,763.94	29,176	1.91	22,867.65
MAINE..............	530,634	13,192.55	65,829	12.41	19,113.43	7,204	1.36	24,711.62
MARYLAND...........	2,009,861	18,461.43	477,250	23.75	27,879.02	63,476	3.16	25,513.59
MASSACHUSETTS......	2,653,158	16,360.66	437,206	16.48	23,212.10	94,821	3.57	21,580.27
MICHIGAN...........	3,834,438	16,009.18	747,014	19.48	22,012.57	100,526	2.62	25,080.69
MINNESOTA..........	2,044,271	14,320.60	357,921	17.51	21,034.23	60,562	2.96	19,757.90
MISSISSIPPI........	905,415	14,300.70	107,020	11.82	26,371.96	16,534	1.83	18,916.00
MISSOURI...........	2,180,437	14,619.46	354,243	16.25	21,419.62	80,011	3.67	25,249.10
MONTANA............	341,499	13,903.09	37,341	10.93	24,937.63	9,069	2.66	20,205.73
NEBRASKA...........	705,704	12,567.07	98,337	13.93	15,314.26	22,066	3.13	16,392.05
NEVADA.............	465,231	16,656.75	61,405	13.20	21,833.74	10,495	2.26	21,946.00
NEW HAMPSHIRE......	418,775	14,904.99	74,374	17.76	20,145.51	7,627	1.82	20,494.14
NEW JERSEY.........	3,321,390	17,770.43	719,946	21.68	26,040.26	89,208	2.69	29,090.31
NEW MEXICO.........	538,119	15,020.49	77,171	14.34	20,132.01	16,203	3.01	22,554.19
NEW YORK...........	7,007,157	16,719.06	1,420,700	20.27	23,775.35	160,275	2.40	27,950.05
NORTH CAROLINA.....	2,657,459	13,560.47	354,711	13.35	21,500.04	41,097	1.55	24,136.16
NORTH DAKOTA.......	273,672	13,694.05	36,359	13.29	18,053.60	8,492	3.10	29,640.24
OHIO...............	4,660,579	16,162.00	1,030,452	22.11	22,197.11	143,216	3.07	24,047.60
OKLAHOMA...........	1,304,765	15,099.90	113,212	8.18	21,090.40	31,009	2.25	17,541.46
OREGON.............	1,212,730	15,707.53	229,909	18.96	22,321.71	34,000	2.01	27,729.54
PENNSYLVANIA.......	4,857,542	15,170.87	957,112	19.70	21,016.40	144,799	2.90	22,091.52
RHODE ISLAND.......	411,074	13,213.03	79,230	19.20	18,590.71	14,600	3.55	24,570.79

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION—Continued

STATE	CIVILIAN WORKFORCE	AVERAGE INCOME	TOTAL IRA'S	% WITH IRA'S	AVERAGE INCOME	TOTAL 401K'S	% WITH 401K'S	AVERAGE INCOME
SOUTH CAROLINA......	1,350,111	$12,063.77	71,790	5.32%	$19,113.04	20,454	1.52%	$17,789.10
SOUTH DAKOTA........	306,577	13,324.42	43,539	14.20	17,110.49	5,770	1.80	23,285.21
TENNESSEE...........	1,917,291	16,095.64	240,166	12.53	26,054.56	30,094	1.99	24,545.47
TEXAS...............	6,790,184	17,060.25	1,144,059	16.06	26,904.09	231,132	3.40	29,621.73
UTAH................	625,403	14,030.72	79,750	12.75	21,314.97	26,754	4.20	23,181.79
VERMONT.............	232,956	12,807.00	31,791	13.65	18,481.94	5,993	2.57	14,179.93
VIRGINIA............	2,610,404	16,924.21	573,143	21.96	25,963.12	55,129	2.11	24,412.44
WASHINGTON..........	1,696,329	16,319.99	259,121	15.20	21,965.30	75,902	4.47	22,947.09
WEST VIRGINIA.......	669,230	13,918.09	58,694	8.77	18,144.50	12,906	1.93	17,460.04
WISCONSIN...........	2,275,370	14,492.64	482,315	21.20	22,642.09	58,703	2.50	23,270.79
WYOMING.............	211,770	15,701.05	31,511	14.00	25,746.75	9,071	4.20	26,087.40

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION

	CIVILIAN WORKFORCE	AVERAGE INCOME	PRIMARY HEALTH PLAN	% WITH HEALTH PLAN	AVERAGE INCOME
Total	98,963,021	$15,960.27	59,041,441	59.66%	$19,332.44
STATE					
ALABAMA	1,412,080	14,604.37	774,513	54.82	17,364.00
ALASKA	169,352	23,860.26	93,161	55.01	27,349.61
ARIZONA	1,220,314	16,141.70	684,885	56.12	20,435.16
ARKANSAS	892,638	11,562.23	431,437	48.33	13,866.56
CALIFORNIA	10,552,286	18,168.23	6,399,558	60.65	21,763.25
COLORADO	1,461,703	17,061.65	766,589	52.44	21,251.12
CONNECTICUT	1,514,791	18,858.37	955,953	63.11	22,539.62
DELAWARE	277,260	16,710.20	183,034	66.02	20,215.84
DISTRICT OF COLUMBIA	262,714	17,309.46	158,379	60.29	19,001.[illegible]
FLORIDA	4,506,621	13,487.39	2,336,052	51.84	15,964.23
GEORGIA	2,432,680	13,829.38	1,450,845	59.64	16,423.64
HAWAII	470,799	16,031.15	293,912	62.43	18,862.92
IDAHO	366,862	15,263.51	216,208	58.93	18,584.26
ILLINOIS	4,867,743	17,600.74	3,201,410	65.77	20,617.00
INDIANA	2,304,353	14,765.10	1,414,632	61.39	18,273.29
IOWA	-1,228,463	14,380.88	610,163	49.67	18,852.15
KANSAS	1,049,375	14,713.55	576,934	54.98	18,483.55
KENTUCKY	1,345,239	13,924.41	806,543	59.96	16,486.96
LOUISIANA	1,528,105	14,750.59	866,594	56.71	18,587.14
MAINE	530,634	13,192.55	301,677	56.85	15,917.77
MARYLAND	2,009,861	18,461.43	1,247,904	62.09	22,370.62
MASSACHUSETTS	2,653,158	16,368.66	1,670,139	62.95	19,420.26
MICHIGAN	3,834,430	16,089.18	2,338,736	60.99	20,457.46
MINNESOTA	2,044,271	14,320.60	1,046,086	51.17	19,166.23
MISSISSIPPI	905,415	14,380.70	517,032	57.10	16,346.60
MISSOURI	2,180,437	14,619.46	1,223,691	56.12	18,143.32
MONTANA	341,499	13,983.09	128,520	37.63	19,409.95
NEBRASKA	705,704	12,567.07	347,126	49.19	16,592.04
NEVADA	465,231	16,656.75	308,700	66.35	16,825.06
NEW HAMPSHIRE	418,775	14,904.99	247,532	59.11	18,653.06
NEW JERSEY	3,321,390	17,770.43	2,136,953	64.34	21,064.10
NEW MEXICO	538,119	15,028.49	275,217	51.14	18,401.10
NEW YORK	7,007,157	16,719.06	4,592,845	65.55	19,731.50
NORTH CAROLINA	2,657,459	13,560.47	1,675,203	63.04	16,272.13
NORTH DAKOTA	273,672	13,694.05	112,634	41.16	19,120.32
OHIO	4,660,579	16,162.00	2,987,830	64.11	19,354.30
OKLAHOMA	1,384,765	15,899.90	666,091	48.10	19,910.57
OREGON	1,212,730	15,787.53	718,674	59.26	18,962.51
PENNSYLVANIA	4,857,542	15,178.87	3,134,437	64.53	18,062.63
RHODE ISLAND	411,074	13,213.83	246,593	59.99	15,820.60
SOUTH CAROLINA	1,350,111	12,063.77	792,912	58.73	14,540.03

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION-Continued

	CIVILIAN WORKFORCE	AVERAGE INCOME	PRIMARY HEALTH PLAN	% WITH HEALTH PLAN	AVERAGE INCOME
STATE					
SOUTH DAKOTA........	306,577	$13,324.42	140,853	45.94%	$17,122.76
TENNESSEE...........	1,917,291	16,095.64	1,201,478	62.67	18,499.87
TEXAS...............	6,790,104	17,060.25	3,905,203	57.51	20,123.29
UTAH................	625,403	14,830.72	335,463	53.64	19,147.81
VERMONT.............	232,956	12,807.00	132,438	56.85	15,662.30
VIRGINIA............	2,610,404	16,924.21	1,598,847	61.25	20,417.09
WASHINGTON..........	1,696,329	16,319.99	896,364	52.84	20,872.24
WEST VIRGINIA.......	669,230	13,910.09	407,751	60.93	17,056.45
WISCONSIN...........	2,275,370	14,492.64	1,382,599	60.76	18,650.03
WYOMING.............	211,770	15,701.05	103,112	48.69	20,896.07

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION

	CIVILIAN WORKFORCE	AVERAGE INCOME	ERISA WORKFORCE				
			ERISA WORKFORCE	AVERAGE INCOME	PENSION COVERAGE	% COVERED	AVERAGE INCOME
Total	90,963,821	$15,960.27	54,362,744	$19,370.00	38,057,537	70.01%	$21,166.48
STATE							
ALABAMA	1,412,800	14,604.37	774,339	16,868.74	484,539	62.57	19,016.61
ALASKA	169,352	23,868.26	81,300	27,071.54	57,594	70.84	28,669.02
ARIZONA	1,220,314	16,141.70	667,093	19,921.34	459,219	68.84	21,292.00
ARKANSAS	392,630	11,562.23	363,465	15,202.54	223,790	61.57	15,739.10
CALIFORNIA	10,552,206	18,160.23	5,484,205	21,969.84	3,778,985	68.91	23,951.62
COLORADO	1,461,703	17,061.65	772,001	20,730.85	513,164	66.47	23,304.09
CONNECTICUT	1,514,791	18,850.37	952,402	22,325.71	718,773	75.46	23,737.50
DELAWARE	277,260	16,710.20	171,231	20,620.45	140,699	82.17	21,063.43
DISTRICT OF COLUMBIA	262,714	17,309.46	167,508	18,097.93	110,027	65.69	19,491.42
FLORIDA	4,506,621	13,407.39	2,234,232	16,020.31	1,202,502	53.82	17,901.90
GEORGIA	2,432,600	13,8[illegible].38	1,289,109	16,502.99	877,787	68.09	17,896.62
HAWAII	470,799	16,031.15	292,597	19,426.50	210,950	72.10	20,580.43
IDAHO	366,862	15,263.51	178,440	19,445.77	133,701	74.93	21,270.81
ILLINOIS	4,367,743	17,600.74	2,963,784	20,549.69	2,126,014	71.73	22,491.30
INDIANA	2,304,353	14,765.10	1,327,223	17,983.85	972,379	73.26	19,039.07
IOWA	1,228,46[illegible]	14,300.88	526,866	18,618.23	405,260	76.92	19,866.17
KANSAS	1,049,375	14,713.55	533,153	18,457.64	339,157	63.61	20,147.28
KENTUCKY	1,345,239	13,924.41	782,846	16,536.73	546,837	69.85	18,327.52
LOUISIANA	1,528,105	14,750.59	821,887	18,058.14	489,681	59.58	20,208.92
MAINE	530,634	13,192.55	296,315	16,035.19	186,154	62.82	17,892.38
MARYLAND	2,009,861	18,461.43	1,248,909	22,206.10	938,236	75.12	24,146.10
MASSACHUSETTS	2,653,150	16,368.66	1,532,262	19,765.00	1,106,403	72.21	20,900.19
MICHIGAN	3,834,430	16,089.10	2,219,312	20,331.03	1,681,127	75.75	22,077.82
MINNESOTA	2,044,271	14,320.60	1,053,306	18,612.43	682,003	64.75	20,881.53
MISSISSIPPI	905,415	14,300.70	489,501	16,070.43	338,417	69.14	17,793.62
MISSOURI	2,180,437	14,619.46	1,181,647	18,334.42	797,335	67.48	20,434.97
MONTANA	341,499	13,983.09	122,143	19,389.33	85,956	70.37	21,165.51
NEBRASKA	705,704	12,567.07	335,143	16,006.79	223,303	66.63	17,829.30
NEVADA	465,231	16,656.75	267,494	19,543.12	173,975	65.04	20,466.71
NEW HAMPSHIRE	418,775	14,984.99	239,522	18,078.63	173,512	72.44	19,791.96
NEW JERSEY	3,321,390	17,770.43	1,889,361	22,216.54	1,333,437	70.58	24,222.06
NEW MEXICO	538,119	15,028.49	299,378	17,987.14	206,446	68.96	18,952.60
NEW YORK	7,087,157	16,719.06	4,194,111	19,802.31	3,046,319	72.63	21,591.80
NORTH CAROLINA	2,657,459	13,560.47	1,557,778	16,345.64	1,046,607	67.19	17,556.03
NORTH DAKOTA	273,672	13,694.05	114,533	17,975.80	66,176	57.78	20,275.66
OHIO	4,600,579	16,162.00	2,756,113	19,517.18	2,134,179	77.43	21,125.85
OKLAHOMA	1,304,765	15,899.90	613,565	20,159.71	381,158	62.12	22,351.84

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION—Continued

	CIVILIAN WORKFORCE	AVERAGE INCOME	ERISA WORKFORCE				
			ERISA WORKFORCE	AVERAGE INCOME	PENSION COVERAGE	% COVERED	AVERAGE INCOME
STATE							
OREGON	1,212,730	$15,707.53	656,610	$19,189.44	474,721	72.30%	$20,870.66
PENNSYLVANIA	4,857,542	15,170.07	2,890,330	18,099.61	2,164,065	74.87	19,454.60
RHODE ISLAND	411,074	13,213.03	205,439	17,350.60	146,356	71.24	18,997.60
SOUTH CAROLINA	1,350,111	12,063.77	751,038	14,301.93	438,610	58.40	16,094.06
SOUTH DAKOTA	306,577	13,324.42	136,190	16,506.57	95,060	69.80	18,262.97
TENNESSEE	1,917,291	16,095.64	1,097,406	18,704.91	828,443	75.49	20,569.37
TEXAS	6,790,184	17,068.25	3,352,600	20,325.04	2,131,402	63.57	22,323.02
UTAH	625,403	14,830.72	275,742	19,393.78	192,724	69.89	21,503.34
VERMONT	232,956	12,807.00	125,100	15,904.30	83,601	66.84	17,506.07
VIRGINIA	2,610,484	16,924.21	1,528,704	20,390.92	1,155,830	75.61	22,414.55
WASHINGTON	1,696,329	16,319.99	848,400	21,075.30	630,601	74.33	22,315.29
WEST VIRGINIA	669,230	13,918.09	377,200	17,176.74	302,197	80.12	18,206.70
WISCONSIN	2,275,370	14,492.64	1,228,703	18,775.41	955,833	77.79	20,246.15
WYOMING	211,770	15,701.05	94,775	20,325.34	66,193	69.84	22,437.30

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION

	CIVILIAN WORKFORCE	AVERAGE INCOME	ERISA WORKFORCE					
			TOTAL IRA'S	% WITH IRA'S	AVERAGE INCOME	TOTAL 401K'S	% WITH 401K'S	AVERAGE INCOME
Total................	98,963,821	$15,960.27	11,899,903	21.89%	$24,730.26	2,418,230	4.45%	$25,570.30
STATE								
ALABAMA..............	1,412,000	14,604.37	62,239	5.04	24,503.17	4,311	.56	13,000.00
ALASKA...............	169,352	23,860.26	19,516	24.01	28,907.22	4,396	5.41	33,129.21
ARIZONA..............	1,220,314	16,141.70	98,031	14.82	27,590.15	30,530	5.70	26,759.42
ARKANSAS.............	892,630	11,562.23	52,630	14.48	19,590.01	11,490	3.16	22,023.24
CALIFORNIA...........	10,552,206	18,160.23	1,223,514	22.31	27,472.77	310,121	5.65	26,856.70
COLORADO.............	1,461,703	17,061.65	109,779	24.50	24,037.56	30,475	4.90	25,109.40
CONNECTICUT..........	1,514,791	18,850.37	210,491	22.10	27,335.37	46,420	4.87	29,661.70
DELAWARE.............	277,260	16,710.20	37,061	21.64	31,064.76	5,043	2.95	29,791.74
DISTRICT OF COLUMBIA	262,714	17,309.46	19,570	11.69	26,308.06	3,573	2.13	28,639.07
FLORIDA..............	4,506,621	13,407.39	354,631	15.87	19,309.07	69,902	3.13	22,655.31
GEORGIA..............	2,432,600	13,029.30	222,043	17.22	22,591.46	37,042	2.87	10,304.04
HAWAII...............	470,799	16,031.15	63,457	21.69	24,644.33	2,576	.80	24,900.00
IDAHO................	366,862	15,263.51	52,636	29.50	22,024.15	4,263	2.39	12,697.97
ILLINOIS.............	4,867,743	17,600.74	761,609	25.70	24,054.17	190,199	6.08	25,766.51
INDIANA..............	2,304,353	14,765.10	245,869	18.53	21,596.30	71,400	5.30	25,294.72
IOWA.................	1,220,463	14,300.00	111,167	21.10	22,520.14	27,345	5.19	23,056.51
KANSAS...............	1,049,375	14,713.55	134,650	25.26	20,424.40	24,674	4.63	23,263.05
KENTUCKY.............	1,345,239	13,924.41	112,325	14.35	21,052.34	16,936	2.16	29,126.96
LOUISIANA............	1,520,105	14,750.59	113,022	13.05	20,903.47	14,218	1.73	25,190.09
MAINE................	530,634	13,192.55	47,040	16.14	19,326.47	6,036	2.04	27,624.20
MARYLAND.............	2,009,861	18,461.43	385,460	30.06	29,234.62	59,590	4.77	26,431.34
MASSACHUSETTS........	2,653,150	16,360.66	335,667	21.91	25,420.00	74,569	4.87	21,710.01
MICHIGAN.............	3,834,430	16,089.10	536,910	24.19	23,920.84	100,526	4.53	25,080.69
MINNESOTA............	2,044,271	14,320.60	256,754	24.30	23,960.20	51,620	4.90	20,517.10
MISSISSIPPI..........	905,415	14,300.70	59,741	12.20	26,069.91	9,005	1.04	24,777.30
MISSOURI.............	2,180,437	14,619.46	265,802	22.50	23,166.40	72,109	6.11	25,805.96
MONTANA..............	341,499	13,903.09	21,530	17.63	24,900.65	8,252	6.76	21,990.00
NEBRASKA.............	705,704	12,567.07	66,314	19.79	16,606.00	16,769	5.00	17,317.50
NEVADA...............	465,231	16,656.75	49,501	18.51	21,305.21	10,495	3.92	21,946.00
NEW HAMPSHIRE........	418,775	14,904.99	55,670	23.24	21,573.02	7,627	3.10	28,494.14
NEW JERSEY...........	3,321,390	17,770.43	542,075	28.69	27,030.04	85,330	4.52	29,898.31
NEW MEXICO...........	530,119	15,020.49	59,661	19.93	21,155.33	16,203	5.41	22,554.19
NEW YORK.............	7,007,157	16,719.06	975,712	23.26	25,552.01	163,710	3.90	28,470.00
NORTH CAROLINA.......	2,657,459	13,560.47	265,914	17.06	23,393.37	41,097	2.64	24,136.16
NORTH DAKOTA.........	273,672	13,694.05	21,340	18.64	19,716.78	6,664	5.82	25,740.62
OHIO.................	4,660,579	16,162.00	785,502	20.50	22,667.82	120,777	4.30	25,066.15
OKLAHOMA.............	1,304,765	15,899.90	77,993	12.71	24,417.97	27,372	4.46	17,452.02

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION—Continued

	CIVILIAN WORKFORCE	AVERAGE INCOME	ERISA WORKFORCE					
			TOTAL IRA'S	% WITH IRA'S	AVERAGE INCOME	TOTAL 401K'S	% WITH 401K'S	AVERAGE INCOME
STATE								
OREGON	1,212,730	$15,787.53	170,675	25.99%	$24,466.57	34,080	5.19%	$27,729.54
PENNSYLVANIA	4,057,542	15,170.87	660,390	23.13	22,710.14	136,240	4.71	23,336.41
RHODE ISLAND	411,074	13,213.83	57,510	20.00	21,305.65	11,174	5.44	26,299.41
SOUTH CAROLINA	1,350,111	12,063.77	52,475	6.99	18,112.72	17,456	2.32	20,362.53
SOUTH DAKOTA	306,577	13,324.42	29,192	21.43	17,749.91	5,011	3.60	22,074.30
TENNESSEE	1,917,291	16,095.64	170,012	15.57	25,440.02	24,674	2.25	24,144.01
TEXAS	6,790,104	17,060.25	745,744	22.24	27,501.41	106,600	5.57	30,540.40
UTAH	625,403	14,030.72	47,622	17.27	23,259.60	20,169	7.31	26,162.50
VERMONT	232,956	12,007.00	10,973	15.16	19,515.40	5,993	4.79	14,179.93
VIRGINIA	2,610,404	16,924.21	440,071	20.04	20,429.70	55,129	3.61	24,412.44
WASHINGTON	1,696,329	16,319.99	185,601	21.00	23,919.44	50,665	6.91	25,534.55
WEST VIRGINIA	669,230	13,910.09	44,090	11.90	21,006.94	10,556	2.00	20,340.49
WISCONSIN	2,275,370	14,492.64	352,761	20.71	24,022.03	55,656	4.53	23,272.16
WYOMING	211,770	15,701.05	19,117	20.17	26,054.06	8,023	8.47	26,007.40

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION

	CIVILIAN WORKFORCE	AVERAGE INCOME	ERISA WORKFORCE		
			PRIMARY HEALTH PLAN	% WITH HEALTH PLAN	AVERAGE INCOME
Total	90,963,821	$15,960.27	45,160,894	83.07%	$20,734.21
STATE					
ALABAMA	1,412,800	14,604.37	569,747	73.50	18,510.95
ALASKA	169,352	23,060.26	66,549	81.06	29,024.20
ARIZONA	1,220,314	16,141.70	531,496	79.67	21,493.62
ARKANSAS	892,630	11,562.23	291,260	80.14	15,757.42
CALIFORNIA	10,552,206	18,160.23	4,580,340	83.66	23,495.02
COLORADO	1,461,703	17,061.65	572,560	74.16	23,094.96
CONNECTICUT	1,514,791	18,850.37	801,456	84.14	23,732.12
DELAWARE	277,260	16,710.20	143,000	83.52	22,301.50
DISTRICT OF COLUMBIA	262,714	17,309.46	124,251	74.10	19,550.34
FLORIDA	4,506,621	13,407.39	1,721,901	77.07	17,119.02
GEORGIA	2,432,600	13,029.30	1,092,460	84.75	17,506.45
HAWAII	470,799	16,031.15	232,651	79.51	20,692.45
IDAHO	366,062	15,263.51	156,292	87.59	20,153.56
ILLINOIS	4,867,743	17,600.74	2,569,753	86.71	21,792.42
INDIANA	2,304,353	14,765.10	1,128,763	85.05	19,045.13
IOWA	1,228,463	14,300.80	409,750	77.77	20,891.32
KANSAS	1,049,375	14,713.55	425,599	79.83	20,211.46
KENTUCKY	1,345,239	13,924.41	664,969	84.94	17,290.11
LOUISIANA	1,520,105	14,750.59	656,090	79.93	20,022.05
MAINE	530,634	13,192.55	242,200	81.77	17,160.03
MARYLAND	2,009,061	18,461.43	1,011,979	81.03	23,092.17
MASSACHUSETTS	2,653,150	16,360.66	1,311,252	85.50	20,909.50
MICHIGAN	3,834,430	16,009.10	1,893,761	85.33	21,740.95
MINNESOTA	2,044,271	14,320.60	829,109	78.72	20,546.37
MISSISSIPPI	905,415	14,300.70	390,493	81.41	17,347.59
MISSOURI	2,180,437	14,619.46	957,109	81.00	19,790.14
MONTANA	341,499	13,903.09	92,714	75.91	21,376.07
NEBRASKA	705,704	12,567.07	250,316	74.69	17,905.66
NEVADA	465,231	16,656.75	229,172	85.67	19,943.17
NEW HAMPSHIRE	418,775	14,904.99	196,420	82.00	19,895.09
NEW JERSEY	3,321,390	17,770.43	1,612,500	85.35	23,202.26
NEW MEXICO	530,119	15,020.49	223,424	74.63	19,664.96
NEW YORK	7,007,157	16,719.06	3,535,500	84.30	21,110.30
NORTH CAROLINA	2,657,459	13,560.47	1,307,002	89.04	17,085.83
NORTH DAKOTA	273,672	13,694.05	83,320	72.75	20,552.64
OHIO	4,660,579	16,162.00	2,325,071	84.39	20,950.42
OKLAHOMA	1,304,763	15,099.90	479,661	78.18	21,990.53
OREGON	1,212,730	15,707.53	546,769	83.27	20,536.83

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION-Continued

	CIVILIAN WORKFORCE	AVERAGE INCOME	ERISA WORKFORCE		
			PRIMARY HEALTH PLAN	% WITH HEALTH PLAN	AVERAGE INCOME
STATE					
PENNSYLVANIA........	4,857,542	$15,178.87	2,494,876	86.32%	$19,161.81
RHODE ISLAND........	411,874	13,213.83	171,511	83.49	18,506.04
SOUTH CAROLINA......	1,350,111	12,063.77	607,919	80.94	15,091.02
SOUTH DAKOTA........	306,577	13,324.42	102,602	75.33	18,678.21
TENNESSEE...........	1,917,291	16,095.64	926,510	84.43	20,273.86
TEXAS...............	6,790,104	17,068.25	2,761,028	82.35	21,599.85
UTAH................	625,403	14,830.72	234,396	85.01	20,749.61
VERMONT.............	232,956	12,807.08	104,022	83.09	16,726.53
VIRGINIA............	2,610,404	16,924.21	1,268,598	82.98	21,779.91
WASHINGTON..........	1,696,329	16,319.99	696,516	82.10	22,068.97
WEST VIRGINIA.......	669,238	13,918.09	320,642	85.01	18,411.75
WISCONSIN...........	2,275,370	14,492.64	1,042,606	84.85	20,472.94
WYOMING.............	211,770	15,701.05	75,030	79.17	21,951.81

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION

	CIVILIAN WORKFORCE	AVERAGE INCOME	AGES 35 AND OVER, ONE YEAR, 1000 HOURS				
			THIS POPULATION	AVERAGE INCOME	PENSION COVERAGE	% COVERED	AVERAGE INCOME
Total	98,963,821	$15,960.27	34,720,408	$20,271.45	24,991,033	71.98%	$22,176.86
STATE							
ALABAMA	1,412,880	14,604.37	502,205	17,207.02	324,531	64.61	19,430.12
ALASKA	169,352	23,868.26	50,275	27,695.70	37,696	74.98	29,802.00
ARIZONA	1,220,314	16,141.70	433,172	20,523.41	323,206	74.63	22,390.86
ARKANSAS	892,630	11,562.23	230,821	15,173.72	144,782	62.72	16,162.46
CALIFORNIA	10,552,206	18,168.23	3,528,116	23,196.08	2,544,350	72.12	24,908.20
COLORADO	1,461,703	17,061.65	416,076	20,834.25	296,067	71.16	22,580.03
CONNECTICUT	1,514,791	18,850.37	622,263	23,687.12	496,155	79.73	24,329.44
DELAWARE	277,260	16,710.20	126,821	21,555.99	101,943	80.38	21,907.82
DISTRICT OF COLUMBIA	262,714	17,309.46	104,718	18,292.11	66,829	63.82	19,891.37
FLORIDA	4,506,621	13,487.39	1,414,294	16,323.27	789,561	55.83	18,453.44
GEORGIA	2,432,600	13,829.30	873,503	17,417.72	606,976	69.48	18,923.94
HAWAII	470,799	16,031.15	202,124	21,152.35	147,641	73.04	22,544.63
IDAHO	366,062	15,263.51	105,662	20,995.99	85,002	80.52	22,803.45
ILLINOIS	4,867,743	17,600.74	1,765,041	21,325.27	1,276,571	72.33	23,574.83
INDIANA	2,304,353	14,765.10	930,979	18,754.74	697,069	74.24	20,151.89
IOWA	1,228,463	14;300.80	345,872	20,120.87	264,177	76.38	21,639.21
KANSAS	1,049,375	14,713.55	326,655	18,646.49	212,060	64.92	20,811.07
KENTUCKY	1,345,239	13,924.41	469,554	17,089.40	339,101	72.22	19,093.93
LOUISIANA	1,520,105	14,750.59	450,630	18,902.30	268,805	59.65	21,163.70
MAINE	530,634	13,192.55	176,945	16,670.56	117,916	66.64	18,417.96
MARYLAND	2,009,061	18,461.43	850,451	23,713.60	639,352	75.18	25,932.76
MASSACHUSETTS	2,653,150	16,368.66	1,034,160	20,830.90	782,904	75.70	21,709.00
MICHIGAN	3,834,430	16,089.18	1,395,324	21,613.37	1,085,557	77.80	23,296.97
MINNESOTA	2,044,271	14,320.60	595,210	20,110.93	392,354	65.92	22,877.66
MISSISSIPPI	905,415	14,300.70	328,611	16,393.17	230,570	70.17	18,434.29
MISSOURI	2,180,437	14,619.46	740,145	19,256.90	503,559	68.04	21,804.47
MONTANA	341,499	13,903.09	70,739	19,094.21	54,124	76.51	20,734.12
NEBRASKA	705,704	12,567.07	204,985	16,026.01	131,156	63.98	17,964.26
NEVADA	465,231	16,656.75	170,442	20,318.32	112,760	66.16	21,305.89
NEW HAMPSHIRE	418,775	14,984.99	167,626	18,562.49	121,793	72.66	20,602.47
NEW JERSEY	3,321,390	17,770.43	1,294,859	22,776.07	936,232	72.30	24,727.54
NEW MEXICO	538,119	15,028.49	184,795	17,997.60	129,215	69.92	19,152.00
NEW YORK	7,007,157	16,719.06	2,896,600	20,543.00	2,151,639	74.28	22,701.11
NORTH CAROLINA	2,657,459	13,560.47	1,007,223	17,172.42	689,749	68.48	18,406.72
NORTH DAKOTA	273,672	13,694.05	61,730	18,900.94	34,909	56.54	23,077.14
OHIO	4,660,579	16,162.00	1,833,127	20,495.52	1,441,353	78.63	22,235.25
OKLAHOMA	1,384,765	15,899.90	333,006	21,175.50	216,076	65.11	24,285.70

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION—Continued

	CIVILIAN WORKFORCE	AVERAGE INCOME	AGES 25 AND OVER, ONE YEAR, 1000 HOURS				
			THIS POPULATION	AVERAGE INCOME	PENSION COVERAGE	% COVERED	AVERAGE INCOME
STATE							
OREGON..............	1,212,730	$15,787.53	421,043	$19,175.97	306,891	72.89%	$20,941.41
PENNSYLVANIA........	4,857,542	15,178.07	1,851,699	18,358.57	1,397,116	75.45	19,717.24
RHODE ISLAND........	411,074	13,213.03	126,280	18,747.09	92,477	73.23	20,038.99
SOUTH CAROLINA......	1,350,111	12,063.77	412,751	14,390.70	254,914	61.76	15,725.45
SOUTH DAKOTA........	306,577	13,324.42	78,535	17,325.19	51,474	65.54	19,917.10
TENNESSEE...........	1,917,291	16,095.64	678,094	19,275.61	521,567	76.92	21,314.51
TEXAS...............	6,790,104	17,060.25	2,006,993	21,547.01	1,330,921	66.31	24,099.46
UTAH................	625,403	14,030.72	163,099	19,709.04	115,527	70.83	22,075.77
VERMONT.............	232,956	12,007.00	74,670	15,992.95	49,900	66.94	17,970.59
VIRGINIA............	2,610,404	16,924.21	1,059,463	21,634.57	813,410	76.78	23,777.79
WASHINGTON..........	1,696,329	16,319.99	536,940	22,579.17	421,968	78.59	23,569.30
WEST VIRGINIA.......	669,230	13,918.09	252,559	17,503.40	190,346	78.53	18,099.16
WISCONSIN...........	2,275,370	14,492.64	754,736	20,793.01	603,060	79.90	22,265.94
WYOMING.............	211,770	15,701.05	50,427	21,091.62	38,639	76.62	22,296.00

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION

	CIVILIAN WORKFORCE	AVERAGE INCOME	AGES 35 AND OVER, ONE YEAR, 1000 HOURS					
			TOTAL IRA'S	% WITH IRA'S	AVERAGE INCOME	TOTAL 401K'S	% WITH 401K'S	AVERAGE INCOME
Total..............	90,963,821	$15,960.27	9,509,820	27.62%	$25,266.43	1,736,916	5.00%	$26,837.40
STATE								
ALABAMA............	1,412,800	14,604.37	47,520	9.46	25,267.90	4,311	.06	13,000.00
ALASKA.............	169,352	23,060.26	14,905	29.01	28,775.49	3,211	6.39	34,400.06
ARIZONA............	1,228,314	16,141.70	91,306	21.10	27,122.04	24,720	5.71	31,970.04
ARKANSAS...........	892,638	11,562.23	43,960	19.05	19,977.13	11,490	4.90	22,023.24
CALIFORNIA.........	10,552,206	18,160.23	999,931	28.34	28,340.94	236,595	6.71	28,260.15
COLORADO...........	1,461,703	17,061.65.	130,255	31.31	24,299.77	19,906	4.70	26,104.03
CONNECTICUT........	1,514,791	18,858.37	166,892	26.02	26,500.92	41,159	6.61	29,751.02
DELAWARE...........	277,260	16,710.20	33,355	26.30	32,150.05	3,707	2.99	32,636.60
DISTRICT OF COLUMBIA	262,714	17,309.46	12,433	11.07	20,309.91	1,022	1.74	35,779.06
FLORIDA............	4,506,621	13,407.39	207,376	20.32	20,473.65	56,757	4.01	24,566.00
GEORGIA............	2,432,600	13,029.30	203,597	23.31	22,625.79	21,990	2.52	17,161.00
HAWAII.............	470,799	16,031.15	50,516	20.95	25,544.02	-	-	-
IDAHO..............	366,862	15,263.51	30,303	36.25	24,770.90	1,742	1.65	11,079.60
ILLINOIS...........	4,967,743	17,600.74	576,314	32.65	24,120.74	104,686	5.93	28,030.01
INDIANA............	2,304,353	14,765.10	193,715	20.63	23,672.32	59,590	6.35	25,621.17
IOWA...............	1,220,463	14,300.00	94,631	27.36	22,900.41	14,752	4.27	30,201.46
KANSAS.............	1,049,375	14,713.55	109,601	33.50	20,176.07	21,167	6.40	22,010.59
KENTUCKY...........	1,345,239	13,924.41	94,695	20.17	22,161.10	3,545	.76	51,940.00
LOUISIANA..........	1,520,105	14,750.59	81,975	10.19	22,943.00	9,273	2.06	31,703.31
MAINE..............	530,634	13,192.55	31,161	17.61	20,704.34	5,199	2.94	25,061.47
MARYLAND...........	2,009,861	18,461.43	306,600	36.06	30,855.67	40,933	5.75	27,577.27
MASSACHUSETTS......	2,653,150	16,360.66	200,810	27.15	25,900.60	46,792	4.52	21,706.20
MICHIGAN...........	3,834,430	16,089.10	402,991	20.00	24,310.22	77,457	5.55	26,305.57
MINNESOTA..........	2,044,271	14,320.60	201,701	33.09	25,396.17	32,955	5.54	21,060.16
MISSISSIPPI........	905,415	14,300.70	49,251	14.99	20,639.20	3,001	1.16	29,320.53.
MISSOURI...........	2,180,437	14,619.46	215,290	29.09	23,512.10	52,407	7.09	26,460.03
MONTANA............	341,499	13,903.09	15,674	22.16	23,293.15	5,390	7.62	24,067.17
NEBRASKA...........	705,704	12,567.07	51,949	25.34	18,901.61	10,110	4.93	21,040.93
NEVADA.............	465,231	16,656.75	40,012	23.40	22,230.41	7,811	4.50	22,395.04
NEW HAMPSHIRE......	418,775	14,904.99	46,392	27.60	21,351.33	6,177	3.60	30,056.07
NEW JERSEY.........	3,321,390	17,770.43	440,933	34.05	28,220.00	60,826	5.32	31,036.11
NEW MEXICO.........	538,119	15,020.49	47,715	25.02	20,234.77	11,955	6.47	23,232.73
NEW YORK...........	7,007,157	16,719.06	822,854	28.41	25,209.20	118,907	4.11	27,150.05
NORTH CAROLINA.....	2,657,459	13,560.47	220,502	22.69	24,161.03	37,306	3.70	24,475.23
NORTH DAKOTA.......	273,672	13,694.05	15,496	25.10	19,203.44	5,210	8.45	27,067.46
OHIO...............	4,660,579	16,162.00	576,460	36.90	23,031.92	101,275	5.52	25,600.57
OKLAHOMA...........	1,304,765	15,099.90	49,964	15.00	25,039.50	27,372	8.22	17,452.02

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION—Continued

	CIVILIAN WORKFORCE	AVERAGE INCOME	AGES 25 AND OVER, ONE YEAR, 1000 HOURS					
			TOTAL IRA'S	% WITH IRA'S	AVERAGE INCOME	TOTAL 401K'S	% WITH 401K'S	AVERAGE INCOME
STATE								
OREGON..............	1,212,730	$15,707.53	133,009	31.59%	$24,793.69	26,017	6.10%	$29,600.49
PENNSYLVANIA........	4,857,542	15,170.87	531,437	28.70	22,705.24	56,100	3.03	22,116.25
RHODE ISLAND........	411,074	13,213.83	39,905	31.66	22,400.40	8,505	6.00	29,020.35
SOUTH CAROLINA......	1,350,111	12,063.77	35,424	8.50	17,302.10	9,545	2.31	26,770.09
SOUTH DAKOTA........	306,577	13,324.42	21,549	27.44	17,912.01	4,106	5.23	22,105.32
TENNESSEE...........	1,917,291	16,095.64	133,341	19.66	24,366.48	19,463	2.87	23,592.40
TEXAS...............	6,790,184	17,060.25	574,757	20.64	26,539.80	129,479	6.45	33,926.64
UTAH................	625,403	14,830.72	41,103	25.20	24,336.06	16,122	9.80	24,959.32
VERMONT.............	232,956	12,807.80	17,121	22.93	19,509.85	5,445	7.29	14,262.03
VIRGINIA............	2,610,404	16,924.21	353,729	33.39	30,070.56	46,917	4.43	25,201.04
WASHINGTON..........	1,696,329	16,319.99	151,292	20.10	24,767.09	45,624	8.50	27,701.50
WEST VIRGINIA.......	669,230	13,910.09	40,017	15.04	21,900.30	10,556	4.10	20,340.49
WISCONSIN...........	2,275,370	14,492.64	297,182	39.30	23,900.40	45,811	6.07	24,872.66
WYOMING.............	211,770	15,701.05	16,412	32.55	26,654.31	4,500	8.92	27,374.10

- Data not available.

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION

	CIVILIAN WORKFORCE	AVERAGE INCOME	AGES 35 AND OVER, ONE YEAR, 1000 HOURS		
			PRIMARY HEALTH PLAN	% WITH HEALTH PLAN	AVERAGE INCOME
Total	90,963,821	$15,960.27	28,870,473	83.15%	$21,754.80
STATE					
ALABAMA	1,412,800	14,604.37	361,015	71.87	19,206.80
ALASKA	169,352	23,060.26	41,645	82.83	30,107.92
ARIZONA	1,220,314	16,141.70	344,345	79.49	22,615.93
ARKANSAS	892,630	11,562.23	184,849	80.08	15,768.15
CALIFORNIA	10,552,206	18,168.23	3,038,355	86.12	24,627.89
COLORADO	1,461,703	17,061.65	310,990	74.74	23,568.06
CONNECTICUT	1,514,791	18,858.37	515,323	82.81	25,473.07
DELAWARE	277,260	16,710.20	101,655	80.16	23,763.38
DISTRICT OF COLUMBIA	262,714	17,309.46	76,729	73.27	20,459.50
FLORIDA	4,506,621	13,407.39	1,087,341	76.80	17,290.87
GEORGIA	2,432,600	13,829.30	737,926	84.47	18,564.65
HAWAII	470,799	16,031.15	161,522	79.91	22,349.07
IDAHO	366,062	15,263.51	91,465	86.56	22,060.04
ILLINOIS	4,067,743	17,600.74	1,527,121	86.52	22,947.09
INDIANA	2,304,353	14,765.10	790,009	84.13	19,900.20
IOWA	1,220,463	14,300.00	202,636	81.72	22,184.99
KANSAS	1,049,375	14,713.55	247,769	75.05	21,321.01
KENTUCKY	1,345,239	13,924.41	390,415	84.05	17,502.33
LOUISIANA	1,520,105	14,750.59	357,407	79.33	21,085.56
MAINE	530,634	13,192.55	150,131	84.85	17,815.54
MARYLAND	2,009,861	18,461.43	601,923	80.18	25,513.92
MASSACHUSETTS	2,653,150	16,360.66	893,220	86.37	22,058.44
MICHIGAN	3,834,430	16,009.10	1,194,134	85.50	23,020.27
MINNESOTA	2,044,271	14,320.60	473,369	79.53	22,279.36
MISSISSIPPI	905,415	14,300.70	260,239	79.19	17,900.40
MISSOURI	2,100,437	14,619.46	596,352	80.57	21,060.23
MONTANA	341,499	13,903.09	50,063	70.77	21,240.26
NEBRASKA	705,704	12,567.07	140,304	68.45	18,910.69
NEVADA	465,231	16,656.75	140,812	82.62	20,851.22
NEW HAMPSHIRE	410,775	14,904.99	130,139	82.41	20,333.64
NEW JERSEY	3,321,390	[illegible].43	1,106,467	85.45	23,806.55
NEW MEXICO	530,119	15,[illegible]	133,765	72.39	20,105.23
NEW YORK	7,007,157	[illegible]6,719.06	2,407,046	85.09	21,766.80
NORTH CAROLINA	2,657,459	13,560.47	806,266	87.99	18,189.10
NORTH DAKOTA	273,672	13,694.05	46,860	75.90	21,695.36
OHIO	4,660,579	16,162.00	1,545,476	84.31	21,925.36
OKLAHOMA	1,304,765	15,899.90	250,377	77.57	22,830.36
OREGON	1,212,730	15,787.53	330,772	80.46	21,330.90

1983 EBRI/HHS CURRENT POPULATION SURVEY MAY PENSION SUPPLEMENT
EMPLOYEE BENEFIT UTILIZATION-Continued

	CIVILIAN WORKFORCE	AVERAGE INCOME	AGES 35 AND OVER, ONE YEAR, 1000 HOURS		
			PRIMARY HEALTH PLAN	% WITH HEALTH PLAN	AVERAGE INCOME
STATE					
PENNSYLVANIA........	4,857,542	$15,170.07	1,549,466	83.68%	$19,622.84
RHODE ISLAND........	411,074	13,213.83	105,410	83.47	19,794.83
SOUTH CAROLINA......	1,350,111	12,063.77	354,167	85.81	14,912.72
SOUTH DAKOTA........	306,577	13,324.42	58,057	73.92	20,149.06
TENNESSEE...........	1,917,291	16,095.64	563,347	83.08	20,991.29
TEXAS...............	6,790,184	17,068.25	1,626,733	81.05	23,175.31
UTAH................	625,403	14,830.72	136,325	83.58	21,272.60
VERMONT.............	232,956	12,807.00	59,064	79.09	16,962.39
VIRGINIA............	2,610,404	16,924.21	974,369	82.53	23,223.06
WASHINGTON..........	1,696,329	16,319.99	462,829	86.20	23,245.00
WEST VIRGINIA.......	669,230	13,910.09	214,434	84.90	18,862.79
WISCONSIN...........	2,275,370	14,492.64	646,871	85.71	22,629.25
WYOMING.............	211,770	15,701.05	40,281	79.80	22,261.84

APPENDIX II

Employer Benefit Tax Expenditures in the Administration's

Budget by Budget Function, Fiscal Years 1983-1985
(In millions of dollars) a/

Provision	1983	1984	1985
Commerce and Housing Credit:			
Exclusion of interest on life insurance savings	$4,335	$4,720	$5,180
Education, Training, Employment, and Social Services:			
Employer educational assistance	40	20	--
Exclusion of employer provided child care	20	40	70
Exclusion of employee meals and lodging (other than military)	680	725	795
Exclusion of contributions to pre-paid legal services plans	40	40	45
Investment credit for ESOPs	1,250	1,375	1,875
Health:			
Exclusion of employer contributions for medical insurance premiums and medical care	15,270	17,625	20,165
Social Security and Medicare:			
Exclusion of Social Security benefits:			
OASI benefits for retired workers	14,035	13,895	12,975
Benefits for dependents and survivors	3,775	3,755	3,765
Disability insurance benefits	1,310	1,225	1,105
Income Security:			
Exclusion of railroad retirement system benefits	780	615	450
Exclusion of workman's compensation benefits	1,885	2,020	2,215
Exclusion of special benefits for disabled coal miners	160	155	155
Exclusion of untaxed unemployment insurance benefits	2,960	2,305	1,800
Exclusion of disability pay	120	75	--
Net exclusion of pension contributions and earnings:			
Employer plans	46,585	50,535	56,340
Individual Retirement Accounts	8,855	9,190	9,840
Keoghs	1,460	1,475	1,530
Exclusion of other employee benefits:			
Premiums on group term life insurance	2,040	2,170	2,380
Premiums on accident and disability insurance	120	120	125
Income of trusts to finance supplementary unemployment benefits	20	20	20
Veterans benefits and services:			
Exclusion of veterans disability compensation	1,815	1,810	1,855
Exclusion of veterans pensions	345	335	340
Total	107,950	114,295	123,125

SOURCE: Special Analysis G, Budget of the United States Government, Fiscal Year 1985.

a/ Budget functions are groups of federal programs or activities that address a common national need. There are 18 budget functions.

STATEMENT OF LANCE D. TANE, MANAGER, THE WYATT CO., WASHINGTON, DC

Senator PACKWOOD. Mr. Tane.

Mr. TANE. Thank you, Mr. Chairman.

My current role is as manager of the flexibile compensation team with the Wyatt Co. In that capacity I have worked with a number of major employers who are currently in the process of assessing and in some cases redesigning their benefit program. I would like to start by saying that I agree with the conclusions that you reiterated this morning. In working with these companies, it's very clear that they do consider tax laws and tax incentives in deciding what benefits they want to offer their employees. And I think it's also very clear that these tax incentives have served to create the current situation where most workers are covered by medical coverage, by retirement plans outside of that provided by the Government.

I think it is also clear that these companies work very hard to ensure that these benefits are provided in the most cost effective manner. And it's difficult for me to imagine the Government providing these benefits more cost effectively than these corporations do with the ever present discipline of the bottom line.

I think clearly the issue then is not whether there should be benefits, but the limit of those benefits. And this is a decision that needs to be carefully considered. But in that context, I would like to spend the majority of the time of my remarks talking about flexibility.

Recently, many major employers have been looking at their benefit programs and deciding that the current one size fits all approach does not make the most sense. They have been adopting an approach where employees can chose which of their benefits they want. I think there are a number of different imperatives that have made this approach probably the only approach that makes sense currently. The demographics of the work force are one of those factors. Whereas in 1960 48 percent of our families had a single wage earner, by 1980, only 33 percent had a single wage earner.

Women in the work force have increased over that same period from 38 percent to 51 percent. Clearly, the needs of our workers vary much more greatly than they ever have before. At the same time, the cost of benefits has risen sharply. And it's very clear that we cannot afford to provide everyone with everything just because the tax incentives require that that be the case.

Many of our employers have also found that through programs of flexibility they are able to significantly increase employee awareness of their benefits and appreciation of their benefits and get them more involved in personally planning for their retirement and their retirement security.

I think it must be recognized that the cost of benefits is of great concern to companies. And that they are along with the Government looking for ways to control benefit costs. But still they do feel that these benefits provide an important part of their social contract.

Some of the experiences of these clients are very interesting. One client that we are working with, when they offered their employees a plan of flexibile compensation that included as options all their current benefits, less than 6 percent of the employees chose the benefits they had in the past. Over a number of different implementations that we have now done, in general, less than 10 percent of the employees choose the benefits that they had in the past. So clearly the ability to choose does provide employees with the opportunity to adapt these programs to their varying needs.

Another thing that takes place is that employee satisfaction with benefits increased with flexible compensation programs. At one client that we work with where we did some statistically valid testing, before the introduction of flexibility, only 48 percent of the employees felt the program met their needs. After the implementation of a flexible program, 93 percent did. And that's without spending any more money. So it's very clear that flexible compensation increases the employees' appreciation, awareness and participation in the benefit process.

Another concern that has been raised is that the flexible compensation programs favor the highly paid. Our research has shown that elections don't support this contention.

I think the problem is that the issues related to flexible compensation have been misunderstood. Flexible compensation in and of itself does not erode the tax base. It's the fact that what it does is highlight incentives that are currently in the tax base without limits. Through flexible compensation programs, the administration has pointed out that the employee jealousy factor is eliminated, thus allowing everyone to choose everything. What is needed is not turning back from flexibility, but a redefinition of these incentives so that the approach is that those things that we feel are important should be made available to all the people. Those things that aren't as important are not necessarily available. An example might include providing some overall limits on the total package of benefits which would be nontaxable.

I think it's interesting to note that many major employers would support this kind of an approach and would probably rely on it to communicate to their employees why they have to cut back benefits.

Thank you very much.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Tane follows:]

FLEXIBLE BENEFITS:

Promoting Individual Choice And Preserving the Tax Base: Reconciling Two Imperatives

TESTIMONY OF
LANCE D. TANE
MANAGER
FLEXIBLE COMPENSATION TEAM
THE WYATT COMPANY
WASHINGTON, D.C.

BEFORE
UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

JULY 30, 1984

My name is Lance Tane* and I manage the Flexible Compensation Team of The Wyatt Company, the nation's largest independent employee benefits consulting firm. The Flexible Compensation Team is the largest professional unit in the country working exclusively on the design and implementation of flexible ("cafeteria") benefit plans for major employers. Our clients include a number of Fortune 100 manufacturers and the 50 largest bank holding companies.

Accordingly, I am focusing my testimony on flexible benefit plans -- which are destined to play a central role in the future of employee benefits in this country. Benefit flexibility is a critical subject for this subcommittee to consider in the development of appropriate tax policy with regard to employee benefits in an overall sense.

The fundamental issue facing legislators is how to reconcile the critical need of today's increasingly diverse work force for greater benefits choice and flexibility with the equally critical need to avoid increasing tax expenditures in the face of unacceptably large budget deficits.

Contrary to popular opinion, these two imperatives -- promoting individual choice in employee benefits <u>and</u> preserving the income tax base -- are not mutually exclusive.

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*The views expressed in this testimony are those of the author and are not intended to represent the views of The Wyatt Company.

It is important to realize that greater choice and flexibility in benefits does not in itself erode the tax base -- it merely surfaces a broad range of underlying tax incentives that have been in the tax code but have not been fully utilized over the years.

Why have these tax incentives not been fully utilized? The answer is that these incentives are available to employees only through their employers -- and employers could not make them readily available until recently.

They could not do so for two interrelated reasons -- the first based on economics and the second on a doctrine of tax law. The economic reason was well explained by Assistant Treasury Secretary John Chapoton in testimony before the Finance Committee last year on S. 640. He said:

> "Prior to the establishment of cafeteria plans, there was a practical limitation on the extent to which employers could provide compensation to employees in the form of non-taxable fringe benefits. Economically, any individual employee would prefer to receive more compensation in the form of non-taxable fringe benefits only if the employee needed or would use the additional fringe benefit as much as the cash payment that otherwise would be paid, less the tax that would be imposed on that cash compensation. The need for additional fringe benefits would differ from employee to employee. As a consequence, the provisions of additional fringe benefits would be sought by some employees and opposed by others. In the past, employees as a group have reached a mutually satisfactory accommodation where the level of fringe benefits offered by each employer is acceptable to the employee group as a whole.
>
> The level of benefits at which any group of employees develops conflicting interests will depend on the type of benefit being considered and the particular circumstances of the employees. For example, all employees may desire medical insurance protection up to a certain level. However, employees without dependents may want to limit the level of employer-provided health insurance to coverage for a single employee. Collectively, these employees will resist reducing their general level of cash compensation in order to provide more extensive insurance protection that would benefit only employees with dependents.

> The establishment of cafeteria plans eliminates 'employee jealousy' as a constraint upon the use of fringe benefits as a principal means of compensation. Under a properly designed cafeteria plan, an employee will never bear any portion of the economic cost of the fringe benefits enjoyed by other employees. Again looking to the example of medical insurance, an employee will not care if another employee receives tax-free comprehensive health care insurance coverage for an entire family so long as he or she can receive either cash or an equivalent amount of compensation in the form of a desired tax-free fringe benefit."

Until recently, employers could not offer their employees this kind of tradeoff without running afoul of "constructive receipt."

Before this doctrine was waived for qualified cafeteria plans by Section 125 of the Internal Revenue Code, if employers offered their employees a choice between taxable and non-taxable benefits, the availability of the choice automatically resulted in taxable income for the employees regardless of what they actually chose.

Thus, the combination of employees' economic self-interest and constructive receipt encouraged employers to purchase a lowest-common-denominator approach to benefits -- to offer a uniform benefits package of theoretically universal appeal for all employees.

For many years, the "one-size-fits-all" benefits philosophy was viable -- and it artifically protected the tax base from the full impact of the tax incentives for all kinds of benefit-related items embedded in the Internal Revenue Code.

But recently, several powerful trends have converged which have rendered traditional fixed benefits obsolete and created an explosion of interest in the kind of benefit flexibility made possible by Section 125 -- and opened up the underlying benefit tax incentives to greater utilization.

There are five major trends which have converged to reshape the benefits environment:

TREND #1 -- The work force has been transformed by massive demographic shifts. In 1960, 48 percent of American families were supported by one breadwinner. But by 1980, only 33 percent still relied on only one income -- and the number is dropping rapidly. During the same 20-year period, women jumped from 38 percent of the work force to 51 percent.

At many of our large corporate clients, for example, the "typical" employee for whom traditional benefits are designed -- a married man with a non-working wife and children at home -- now represents less than 15 percent of the work force!

TREND #2 -- Benefit costs have soared, largely due to virulent medical inflation. According to the annual Chamber of Commerce study, average company benefit costs have shot up from 19 percent of payroll in 1951 to some 37 percent today.

In dollar terms, the 1,500 companies in the Chamber study spent $510 billion on benefits in 1982 -- about three times what they paid 10 years earlier. Not surprisingly, healthcare cost-containment is a critical concern for many employers.

Companies are attempting to control costs in many different ways. One of them is flexible benefits, because unnecessary benefits (e.g., high levels of life insurance for single employees) or redundant coverage (e.g., overlapping medical plans for two-career couples) can be avoided.

TREND #3 -- The recent severe recession has given even greater urgency to controlling benefits costs. Employers have begun to realize that traditional benefits programs are really blank checks -- management is essentially committed in perpetuity to a specific market basket of benefits, regardless of future cost.

Flex plans, however, redefine the company's benefits obligation in dollars rather than in goods and services. This rips up the blank check. Each employee is allocated a certain number of benefit credits, and every year the employer decides how much to increase the benefit allowance.

Because flex increases the value of benefits to employees, it can be a powerful tool to accomplish any of three objectives:

1. Add new benefits at lower cost than through a fixed benefit plan.
2. Increase the value of benefits to employees without increasing costs.
3. Maintain the value of benefits to employees while reducing costs.

TREND #4 -- A computer revolution has swept the country. Employers who had been scared off by the complexity of administering a different benefit plan for each employee now have powerful new technological tools at their disposal.

Sophisticated software has become available to handle every aspect of the administration of individually tailored benefit programs for companies of all sizes. There are even versions of such software designed for the personal computer.

TREND #5 -- A body of experience has developed which proves that flex plans are feasible for employers. And that employees like them -- even in cases where companies have actually reduced their benefit expenditures. Several statistics from companies we are working with are particularly revealing:

At one major client, only 6 percent of employees chose to buy back their old benefit package when given the chance. At another, employee satisfaction with the benefits package rose from 48 to 93 percent after management introduced a flex plan -- and the company's costs didn't increase at all. At a third, the company is saving $2 million a year and employees prefer the new plan to the old!

As a result of these forces, flexible benefit plans are now catching on rapidly in companies large and small in all industries and areas of the country. Flex plans are particularly popular in companies where the employee population tends to be young and female.

They are also becoming widespread in high-technology and professional service businesses, as well as in fields such as banking that are evolving rapidly -- and which must attract, motivate, and retain a higher caliber of employee than ever before.

In addition, utilities and manufacturing companies have turned to flex -- and unions are starting to get past their initial negative reactions and realizing the advantages to both labor and management.

Hundreds of companies large and small are making their benefits more flexible -- ranging from adding elements of choice to conventional plans to establishing comprehensive flex plans.

There is a groundswell of employee interest across the country. And the press -- always looks to spot a trend -- has caught on to the story.

Flex is an idea whose time has come. It is too powerful to stop because it simply makes too much sense and responds too well to the needs of today's work force.

Giving people the freedom to control their own economic decisions strikes a deep chord in the American psyche. Moreover, promoting individual initiative is consistent with the philosophy of this Administration and eliminating artificial barriers to consumer choice is in step with the deregulatory mood of the times.

And contrary to the prevailing notion in Washington, flexible benefits do not discriminate in favor of the highly paid and the concept has powerful appeal to people in all income brackets.

On a legal and regulatory level, tough anti-discrimination requirements are written into both the recently issued proposed regulations for Section 125 and the newly enacted Deficit Reduction Act of 1984.

In practice, employees in all salary categories tend strongly to favor flexible benefits. As benefits consultants, our experience is that 85 to 95 percent of employees choose to rearrange their existing benefit package when given the chance to do so with a flex plan. The 85 to 95 percent range holds steady across the wage spectrum.

Finally, a sharp contrast to conventional wisdom is the fact that flexible benefits appear to be of even greater interest to the lower-paid than to the higher-paid. In a recent nationwide attitude survey conducted by the Opinion Research Corporation, 49 percent of respondents in all income brackets said that when considering roughly equal job offers from two different companies, they would be more likely to choose a company offering flexible benefits over one with conventional fixed benefits.

However, an extraordinary 59 percent of employees in the study earning $15,000 per year or less said they would be more interested in a job that offered a flex plan over one that did not. By comparison, only 48 percent of the respondents earning $35,000 per year or more were similarly motivated by a flex plan. So much for the myth that flex appeals only to the highly-paid.

However, as the flex trend rapidly gains momentum, there is increasing concern is some quarters that it may lead to erosion of the tax base because employees have access to a larger portion of their total compensation in a non-taxable form.

What is to be done? The answer is not to try to turn back the clock and crack down on individual choice -- but to rethink the underlying tax incentives. It is my belief that some of these longstanding incentives have become misfocused and need to be reconsidered.

For example, let's look at medical insurance, the example cited by Assistant Secretary Chapoton.

All payments to covered employees from employer-sponsored medical plans have long been non-taxable to these employees. However, for people who are not participants in an employer-sponsored plan, any medical expenses incurred up to 5 percent of adjusted gross income are non-deductible and must be paid for with after-tax dollars.

This contrasting tax treatment leads to some important questions:

- Did Congress intend to have payments for everything covered by employer-sponsored medical plans go completely tax-free?
- Should there be a distinction in tax status between essential and non-essential coverage? Are eyeglasses deserving of the same tax incentives as heart surgery?
- Was the enormous increase in medical costs -- and hence the value of this tax exclusion -- foreseen?
- Philosophically, is it fair to discriminate between employer-provided and employee-purchased medical benefits? Why should there be unequal tax incentives?

One way to redress this serious inequity would be to designate as taxable income to the employee a portion of the payments -- not the coverage but the proceeds -- that he or she receives from an employer-sponsored medical plan.

For example, if we want to equalize the tax incentives for insured and uninsured medical expenses, payments for employer-sponsored medical plans could be made taxable up to 5 percent of adjusted gross income.

This would continue to protect employees against catastrophic expenses and give them a tax incentive for medical cost-containment. It would also avoid penalizing choice, instituting a regressive tax, or creating an administrative burden for employers.

This kind of approach could also significantly increase tax revenues. Based on a reasonable set of assumptions, additional Federal tax revenues in the neighborhood of $15-25 billion a year could be generated if payments from employer-sponsored medical plans were made taxable up to 5 percent of W-2 income.

If proceeds were made taxable up to only 1 percent of W-2 income, this would still raise $4-6 billion a year -- not an inconsequential sum in view of the fact that the recent tax bill will raise only some $50 billion over three years.

This is just one possible way to carry out what must be a fundamental attribute of tax policy regarding fringe benefits -- it must accommodate individual choice. The tax treatment of benefits provided by employers through a "one-size-fits-all" plan or through a flex plan -- or purchased by an individual outside of any plan -- should be the same.

The issue is the extent of the tax incentives various kinds of fringe benefits deserve -- not the form in which the benefits are provided.

This leads to two other possible approaches that would help preserve the tax base, while avoiding the imposition of a tax penalty on choice.

The first approach is to scale back the incentives for various types of benefits considered less deserving of tax-favored treatment. Do benefits such as van pooling, elective surgery, and emergency medical treatment all deserve the same level of tax exemption? Should some items lose their tax benefits? Should others have them reduced but not eliminated?

What is required are carefully considered judgments and even-handed assessments of the proper level of incentives in particular cases.

Regardless of the determinations, this approach would promote choice because the form in which the designated benefits are offered would become irrelevant.

The second approach is simply to put a dollar cap on the total value of fringe benefits that can be excluded from an individual's taxable income every year.

Contrary to popular opinion, employers would support a reasonable cap. Corporate management is every bit as interested as Congress in braking the growth of benefits. Research shows that the increased costs of providing more non-cash compensation to employees in the form of benefits does <u>not</u> reduce employers' overall compensation expenditures. The establishment of tax incentives for benefits creates employee expectations and pressure for these benefits. That expectation and pressure is for the employer to provide those benefits in addition to whatever direct compensation the employee felt he was otherwise entitled. While most employers agree it is socially desirable to provide a core of benefit protection to their employees, unlimited tax incentives simply serve to increase employee expectations for the provision of more and more expensive benefit packages. The implementation of reasonable limits on non-taxable benefits would be well received by many major employers and could be used by those employers as a rationale for benefit cutbacks.

A cap on total benefits would also avoid penalizing choice, again because the form in which benefits are offered would be irrelevant, and also because each individual could select whatever types of benefits he or she most wanted -- all that would matter would be the aggregate value of the benefits.

These are only a few ways in which the underlying tax incentives for benefits could be refocused to protect the tax base without penalizing individual choice. No doubt there are many other viable approaches.

The central issue is the extent of the tax incentives various kinds of benefits deserve and which fiscal realities can accommodate -- not the form in which the benefits are provided.

The tax treatment of benefits provided by employers through either a conventional "one-size-fits-all" plan or a flex plan -- or purchased by an individual outside of any plan -- should be the same. This principle should become a cornerstone of tax policy toward employee benefits.

However, making it a reality will require Congress to grapple with many difficult and controversial benefit issues at the very heart of the present structure of tax incentives.

The fact that this Committee is taking three days to hear testimony on fundamental tax issues affecting employee benefits is a hopeful sign.

Unfortunately, benefits policy has been set in chaotic, patchwork fashion for many years. Critical benefits issues have been addressed almost exclusively in the context of loophole closing and frantic last-minute revenue raising.

Benefits are no longer an arcane subject of interest only to actuaries and consultants. They have long fulfilled important social needs and have contributed significantly to the nation's economic wellbeing over the past generation.

But today, with the groundswell of interest in shaping benefits packages to meet the needs of employees of all kinds -- including young singles, divorced mothers, two-career couples, and old workers -- benefits have become a critical issue for almost every constituency in American society.

More than ever before, employers need a clear, consistent, and unambiguous framework -- a coherent set of tax policies which don't change every year -- to move ahead with to design responsible and effective benefit plans that meet the needs of both labor and management.

This tax framework must recognize that benefit flexibility is an idea whose time has come -- and that individual choice must not be restricted in a misguided attempt to protect the tax base.

STATEMENT OF EUGENE M. KALWARSKI, F.S.A., MILLIMAN & ROBERTSON, INC., WASHINGTON, DC, ON BEHALF OF THE NATIONAL EMPLOYEE BENEFIT INSTITUTE

Senator PACKWOOD. Mr. Kalwarski.

Mr. KALWARSKI. Good morning, Mr. Chairman. Mr. Chairman, I'm here to testify on behalf of the National Employee Benefit Institute. With me here today is Thomas Schendt, associate director of the institute. I apologize that Mr. Sebastian and Mr. Rodriques, who were listed as joining me in this presentation—are not here due to conflicting schedules.

The National Employee Benefit Institute is an organization composed of Fortune 1000 sized companies which share a common interest in legislation and regulations which impact benefit planning. NEBI represents more than $100 billion in pension assets, and its members employ hundreds of thousands of workers who are covered by many types of benefit programs.

The text of NEBI's written testimony as submitted for the record was prepared through the combined efforts of benefit managers of the following major companies who happen to serve on a steering committee of NEBI: The 3M Co., American Can Co., Atlantic Richfield Co., Conoco Inc., First Interstate Bancorp, Hunt Wesson Foods, Inc., Security Pacific National Bank, and Southern California Edison.

Our written testimony focuses broadly on three major areas—the economic and fiscal implications of the current employee benefit tax policy, a discussion of the labor force currently covered by employer paid tax favored benefits, and the historical and social medium in which employee benefit plans, as we currently know them, began. In my oral testimony I'm just going to cover some of the key points from the written testimony.

With respect to economic and fiscal implications, we point out that only a small portion of employee benefit related revenue is permanently lost to the Treasury. While there are few tax free benefits, most employee benefits are merely tax deferred or fully taxable. Further, the tax exempt treatment accorded by Congress to the relatively small amount of fringe benefit payments that are tax exempt to the worker reflect a policy commitment to ensure the provision of medical coverage to as broad a cross-section of the American population as possible, and to encourage the private sector to assume much of the responsibility for this coverage.

Employer sponsored retirement plans are a major source of savings for the majority of current pension participants. There is a two-fold economic consequence of the post-ERISA trend toward greater retirement savings and company sponsored plans. First, there will be reduced pressures on Government. This will enable our nation to better cope with the huge Social Security deficits which are predicted for the coming years. By whatever means the Government must pay for some portion of retirement benefits, Congress must choose whether the Government will take a more active role to the administration of the giant Social Security system or continue to be an inactive participant which pays through reduced revenues. Congress must determine whether it is in the Nation's best interest for the Government to shoulder more of this burden.

The second result of having a Nation of financially secure retirees is that more deferred tax dollars will eventually find their way to the Treasury as postretirement tax payments. We caution that more retirement dollars will be needed in the future. As an actuary, I know that what is needed to support a postretirement population with a relatively short remaining life expectancy is quite different from the resources that are going to be needed in the 21st century with the maturing baby boom generation and advancements in medical technology leading to longer life expectancy.

We want to make the point that a broad based labor force shares in employee benefits. One of the more frequently voiced concerns of employee benefits is the assertion that the current tax structure has created a system benefiting the corporation and the highly compensated individuals by providing deductions and tax shelters. NEBI disagrees with this assertion, and data available at member companies repudiates this assertion. And although the private pension system or private benefit system may not be perfect in design and delivery, the population participating in fringe or retirement plans is larger than ever and is virtually identical to the composition of employment force as a whole.

In summary, I want to point out that tax incentives to employers have improved the flexibility, and innovation in approach and design, to accommodate different geographic areas, age groups, and employee needs. This would not be possible if the Government provided these benefits directly and removed the tax incentives that compel employers to provide the benefits.

In conclusion, Congress, business, and labor have cooperated for over 50 years in setting up a joint public-private employee benefit system. Before upsetting that balance, Government must consider this complex structure. Congress has listened to business and labor and has been responsive to their needs in this area for many, many years. To look now to the future, we ask the subcommittee and the full Congress to decide whether the real social and long-term revenue costs of tax revenue increases benefitting the corporation and the highly compensated individuals by providing deductions and tax shelters. NEBI disagrees with this assertion, and data available at member companies repudiates this assertion. And although the private pension system or private benefit system may not be perfect in design and delivery, the population participating in fringe or retirement plans is larger than ever and is virtually identical to the composition of employment forces as a whole.

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Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Kalwarski follows:]

national
employee
benefits
institute

NEBI

TESTIMONY OF

NATIONAL EMPLOYEE BENEFITS INSTITUTE

BEFORE TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE

OF THE

SENATE FINANCE COMMITTEE

JULY 30, 1984

Presented by:

Eugene M. Kalwarski, F.S.A.

Principal and Manager of the Washington D.C.

Office of Milliman & Robertson, Inc.

Accompanied by:

- Melvyn J. Rodrigues, Manager of Benefits Research, Atlantic Richfield Company

- Thomas G. Schendt, Associate Director National Employee Benefits Institute (NEBI)

2550 M Street, N.W., Suite 785, Washington, D.C. 20037 (800) 558-7258

NATIONAL EMPLOYEE BENEFITS INSTITUTE

INTRODUCTION

The National Employee Benefits Institute ("NEBI") is an organization composed of Fortune 1000-sized companies which share a common interest in legislation and regulations which impact benefit planning. NEBI represents more than $100 billion in pension assets, and its members employ hundreds of thousands of workers who are covered by many types of benefit programs.

The text of the NEBI testimony was prepared through the combined efforts of benefits managers at the following nine member companies who served on a steering committee: 3M Company, American Can Company, Atlantic Richfield Company, Conoco, Inc., First Interstate Bancorp., Hunt-Wesson Foods, Inc., Security Pacific National Bank and Southern California Edison. Although this testimony necessarily reflects these companies' experiences as large employers, the composite employee group depicted in this joint project represents an extremely diverse workforce who live and work in all regions of the United States. The employees described in this testimony include the young and old, male and female, married and single, those who perform manual and clerical jobs and those who have technical, professional, managerial or executive positions. The one characteristic they share is their employment by major companies who are actively interested in the current health and welfare of their employees and dependents, and who want to provide economic security in the event of their separation from service, retirement, death or disability.

NEBI wishes to express its appreciation to the Taxation and Debt Management Subcommittee of the Senate Finance Committee for the opportunity to present testimony and supporting data concerning tax policy issues related to employee benefits. We strongly support your commitment to develop an ongoing fiscal policy which recognizes the inevitable impact that changes with respect to taxation of employee benefits will have on the continuing viability of other major policy areas and national goals.

Millions of American workers and their families count on private benefit plans as a primary or supplemental source of current assistance and future security. The Internal Revenue Code and regulations, ERISA, ERTA, TEFRA and innumerable labor laws and regulations have created a complicated, interrelated, regulatory framework upon which thousands of intricate benefit programs have been built. Public programs have assumed the continued existence and vitality of private ones and vice versa. Congress, business and labor have all contributed to the final product. It is not surprising that fringe benefit legislation and regulations, as well as the plans which they govern, reflect a balance among competing revenue, commercial and social interests.

Our testimony will cover three major areas: the economic and fiscal implications of the current employee benefit tax policy; a discussion of the labor force currently covered by employer-paid, tax favored benefits; and the historical and social medium in which employee benefit plans as we currently know them germinated.

ECONOMIC AND FISCAL IMPLICATIONS

Large federal deficits have caused widespread concern in the executive and legislative branches as well as in the private sector. Although there is little dispute that something must be done to reduce the deficit levels, few programs or persons are willing to assume the role of "bullet biter" voluntarily. Congress has been unduly pressured to cut spending and increase revenues without raising taxes or disturbing anyone's favorite program. This cannot be done. A reevaluation of many tax exemptions, deductions and credits is one logical approach, and may provide an opportunity to eliminate some inadvertent or obsolete exclusions. But before any changes are warranted, it is appropriate to consider carefully the reasons for creating each "tax expenditure" and the impact that its removal would have on the economic and social well-being of the American people.

The current focus on employee benefits as a potential source of substantial additional revenue presupposes two premises: that a significant amount of revenue is permanently "lost" through benefit programs, and that the losses are not justifiable in light of the more compelling revenue considerations. NEBI disagrees with both of these propositions.

1. Only a small portion of employee benefit-related revenue is permanently lost to the Treasury. Employee benefits may be divided into three basic categories: tax free, tax deferred and fully taxable.

(a) Tax free benefits. Health-related benefits are the primary component in the "lost revenue" category of tax free benefits. Employers contribute an average of 5% of payroll to provide health-related benefits. To the extent payments are made to health services providers who are subject to income tax (such as physicians), the payments will be taxed to a taxpayer (the provider) soon after employers make the payments.

(b) Tax deferred benefits. The second category, tax deferred benefits, includes pension, profit sharing and other employee savings plans. Although contributions to these plans reduce current revenue, the deductible contributions will eventually return, interest augmented, to the income stream. Even after adjusting for inflation and tax breaks for the recipient, one study shows that as much as 60% of the contribution amount will return to the tax base as taxable income.[1] Federal revenues are reduced to a small extent by tax credit employee stock ownership plans (commonly called "PAYSOPs"). However, the reduction is arguably offset by the increased productivity of workers who become company shareholders.

(c) Fully taxable benefits. The majority of "benefit" dollars do not receive tax-favored treatment. According to U.S. Chamber of Commerce figures, over two thirds of employee benefits (23.5% of payroll) are fully taxable, discretionary employer-paid benefits such as paid vacation, holidays, lunch periods and sick leave, most of which are subject to both income and Social Security taxes.[2] Another 9.5% are in the form of legally required employer payments (Social Security, paid rest periods, unemployment compensation insurance and worker's compensation insurance). Accordingly, there are no revenue enhancement possibilities for the majority of benefit dollars currently spent on behalf of U.S. workers.

2. Lost revenue is justified by balancing considerations. The tax exempt treatment accorded by Congress to the relatively small amount of fringe benefit payments that are tax exempt to the worker reflect policy commitments to ensure the provision of medical coverage to as broad a cross section of the American population as possible and to encourage the private sector to assume much of the responsibility for this coverage. Thus far, the people of this national have indicated a strong preference for a private health care system over a national health insurance system (such as that in place in

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[1]S. Korczyk, Retirement Security and Tax Policy (Washington, D.C., Employee Benefit Research Institute, forthcoming).

[2]Employee Benefit Research Institute, Why Tax Employee Benefits?, Table 1. (Washington, D.C., 1984).

Great Britian). Actual tax revenues "lost" in implementing this country's private health care system should be compared to the administrative cost of a government-sponsored program. To imply that taxation of health care benefits would enhance revenue rolls dollar for dollar overlooks the hidden costs of collecting this revenue.

3. Employer-provided health benefits are delivered at a relatively low cost. Since the 1960s, our member companies have experienced a dramatic rise in the cost of providing health care coverage for their employees. As one example, Conoco reports that in 1970 its medical plan was funded at 1% of the cost of its payroll. Today it is 6% of payroll. Conoco is only one of the victims of this phenomenon. However, the private health care system is not the cause of rising health care costs and should not be looked to as the source of the solution.

In making such a statement we do not intend to imply that the private delivery system is without fault, nor do we minimize the crisis caused by the rise of health care costs. NEBI companies, along with large and small employers everywhere, have begun to implement serious programs to contain rising health care costs. Current efforts include greater employee cost sharing, tighter control of benefits, sophisticated data monitoring systems, employee health incentives and employee communication programs. Member companies report plans operating at a high level of efficiency, with 95% of medical plan dollars being paid out as benefits.

Our members believe that many factors have contributed to the health care cost explosion. The high cost of new technology is a primary catalyst of cost increases. Other factors include excessive hospital capacity, unnecessary hospital utilization, oversupply of physicians with target income, noncompetitive practices and public and private insurance plans with open reimbursement policies. NEBI believes that Medicare, as the single largest health care plan, can and should assume a leadership role in holding down the cost of medical care delivery. However, the companies represented by this organization do not believe that a more comprehensive government-sponsored health care program would alleviate the health care cost crisis. In fact, most cost-saving techniques employed by companies today started through the efforts of a few innovative companies. Without experimentation by many companies and competition among providers (generated by industry's concern for high costs), new and more efficient delivery systems would not emerge.

4. Retirement plans are major sources of savings for the majority of current pension participants. It has long been part of our national economic policy to encourage savings and investment by American workers. Yet, Japan and the Scandinavian countries have personal savings levels which approximately triple the American rate of under 5% of net pay. NEBI member companies indicate that their profit sharing, savings and thrift plans are the sole or major voluntary savings programs for most employees. Just as important, company-paid pension and other retirement plans will be the major source of income for future retirees.

One of the chief characteristics of the new industrial age was reduced personal retirement savings, requiring government to assume an unfamiliar role in providing assistance for the post-employment years. Tax incentives provided to companies and their employees in order to encourage retirement self-sufficiency are no less valid government tax expenditure today than when first established.

5. Current and future employees will retire with larger savings. There is a two-fold economic consequence of the post-ERISA trend toward greater retirement savings in company-sponsored plans.

(a) Reduced pressures on government. Future retirees will be less dependent on Social Security or Medicare due to longer participation in defined benefit and defined contribution plans. The stronger the private retirement system, the more prepared we will be to cope with the huge Social Security deficits which are predicted for the coming years. At some point in the near future, economics will force us to take a hard look at our public old-age health and welfare delivery system.

By whatever means, government must pay the cost for retirement benefits. Congress must choose whether the government will take a more active role through the administration of the gargantuan Social Security system or continue to be an inactive participant which "pays" through reduced revenues. Congress must determine whether it is in the nation's best interest for government to shoulder more of this burden.

(b) Assets paid out of retirement plans will be taxed. The second result of having a nation of financially secure retirees is that a much higher percentage of deferred tax dollars will eventually find their way into the Treasury as post-retirement tax payments. Employees' income tax brackets will probably not drop as dramatically after retirement. Our members report that their retirees are leaving the work force with a retirement income ranging from 40-100% of their pre-retirement earnings. The higher percentages are at the lower end of the wage scale.

Even considering the various tax advantages (such as rollovers and ten-year forward averaging) given to the benefit recipient, the Treasury is not permanently losing, dollar-for-dollar, the amount of money calculated to be benefit-related tax expenditures. For example, in 1983, Conoco's annual retirement plan contribution (and tax deduction) was $27 million. The same year over $46 million (all taxable income) was paid to about 3700 retirees. As the number of vested employees continues to grow, and they earn a larger pension benefit due to longer service under the plan, the government can anticipate more recaptured revenue. In fact, the fairly conservative funding standards adopted by most corporations, improved retirement benefits to employees, longer life expectancies for current and future retirees and the changing demographic distribution which will accompany the aging of the baby boomers will create an environment in which the difference between tax dollars deferred and recovered is narrowed dramatically. Tax recoveries may even exceed deductions early in the next century.

6. <u>More retirement dollars will be needed</u>. The demographic changes expected as America enters the twenty-first century should not be overlooked. The retirement planning implications are enormous. What is needed to support a small, post-retirement population with a relatively short remaining life expectancy is quite different from the resources required to maintain at an adequate income level a far larger, longer-living group. Although never intended to supply full retirement income, Social Security and Medicare will be less prepared to cope with the twenty-first century's population distribution and culture. Inflation is another serious problem. Carefully planned retirement savings must account for dollar dilution in the post-employment years. Cost of living increases - and the funding necessary to supply them - will become even more important.

We, as a nation, have given much thought to these and similar issues beginning with the Revenue Act of 1921 (exempting interest income on trusts for stock bonus or profit-sharing plans from current taxation) and continuing through to the most recent tax law. We are only now beginning to appreciate the post-ERISA economic impact of well-funded, broad-based private pension coverage.

A BROAD BASED LABOR FORCE SHARES IN EMPLOYEE BENEFITS

One of the more frequently voiced concerns with employee benefits is the assertion that the current tax structure has created a system benefitting the corporation and highly compensated individuals by providing deductions and tax shelters.

ERISA was the first comprehensive attempt to guarantee that retirement benefits would be widely available on an equitable basis. More legislation followed. Nondiscrimination rules have been enacted to insure that both use and availability of statutory fringe benefits are nondiscriminatory. The top-heavy rules of section 416, contribution and benefit limitations under section 415, and relevant sections of the Age Discrimination in Employment Act, among others, have further assured widespread availability of employee benefits. In fact, there is great concern that Congress has gone too far in assuring nondiscrimination. The complexity of and disincentives inherent in recent legislation (such as the top heavy rules in TEFRA) threatens the continuation of retirement plans, especially defined benefit plans and plans maintained by small employers.

The body of laws governing the employee's retirement benefit incorporates such features as the following: fiduciary responsibilities of all plan sponsors, trustees, administrators, consultants, attorneys and others; reporting and disclosure requirements; minimum funding standards; nondiscrimination tests; and tax incentives. Among the plan watchdogs are: the participants themselves; the business community; the plan fiduciaries; the Internal Revenue Service; the Department of Labor and the Pension Benefit Guaranty Corporation. Current and future benefit recipients can be confident that their employer-funded retirement savings will be available as expected.

New legislation has focused upon incidental discriminatory impact issues, such as breaks in service related to maternity or paternity leave and gender-based vesting gaps. NEBI believes that legislation has been an appropriate remedy where large numbers of workers have been adversely affected by certain legal requirements or commonly-included plan provisions. It is our contention, however, that after ten years of operating under ERISA, the benefit plan problems which deserved legislative solution have been virtually eradicated, and any remaining discrimination (real or alleged) through by plan design or administration are more appropriately dealt with by market forces.

A competitive advantage in the marketplace is a primary impetus for offering fringe benefits and retirement plans. Regardless of any tax advantages to the company or participant, it is illogical to assume that an employer would provide any benefit in lieu of the more easily understood and administered direct compensation if there were not pressures from within the marketplace to do so. And although the private system may not be perfect in design and delivery, the population participating in fringe and retirement plans is larger than ever, and is virtually identical to the composition of the employment force as a whole.

1. Coverage and vesting gaps between men and women are narrowing as more women enter and remain in the work force. Statistics show that more than one half of adult women now work outside of the home (as compared with one third in 1960 and an expected 80% by 1985). The figure rises to 70% for adult female "baby boomers." With a growing awareness of the political and economic force generated by this expanding group, both legislative initiatives and market factors have provided these women with greater and more equitable benefits than ever before.

NEBI respondents report a closing gender gap in employment and vesting. One example is First Interstate Bancorp. This company has a rather atypical gender mix of approximately 60% female to 40% male. Although an observer might assume that men would dominate the long tenure positions (executive and managerial), which would result in a widely disparate male-female mix at the retiree level, this is not the case. Of the company's 3603 actual retirees, 58% are female and 42% male. Women at this company are becoming vested and staying at First Interstate Bancorp. until retirement.

Certain fringe provisions are a reflection of the large number of women who remain in the work force through their child-bearing years. Hunt-Wesson cites as an example its liberal maternity leave policy (offered as part of its sick leave and disability plan), which can provide full pay or 60% of pay for six weeks with an additional six weeks off at 60% of pay if medically indicated.

Another example is the dependent care assistance program. In many companies this program has made economically feasible, for many women with small children, the decision to seek and retain employment outside the home. It is not only the working mother who benefits from this assistance. The accessibility of quality child care at more affordable prices is advantageous for the entire family.

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There are other benefits, such as educational assistance, which are more widely utilized by women and lower income wage earners than by the older and higher-paid employees. Atlantic Richfield's (ARCO) educational assistance program is evidence of this tendency. ARCO reports that its program's primary participants are young female clerical workers who are at the lower end of ARCO's wage scale. These women are returning to school with ARCO's assistance in order to obtain the skills to qualify them for management track positions. Not only are these young clerical workers benefited personally by the availability of educational assistance, the employer obtains the benefits of a more diverse management team in an industry that has historically tended to be dominated by men at all levels.

2. Lower income individuals would suffer severe economic consequences if required to purchase or pay for benefits currently provided by employers. Although anticipated retirement income needs and the size of retirement benefits will vary along income lines, the cost of many fringe benefit programs, including large catastrophic medical and other welfare benefits (such as dental, disability and life insurance) are totally independent of income level.

According to a 1982 Bureau of Labor Statistics survey, corporations paid 65% of all health insurance premiums. Also, 93% of all workers employed by the surveyed employers are covered by long and short term disability insurance. For example, First Interstate Bancorp.'s health insurance plan requires a premium of up to $246 per month for family coverage, of which the employee must pay approximately 25%. If employers did not pay the majority or all of the health care premiums, the impact on the $20,000 combined income family would be much greater than on the $80,000 combined income family. The financial burden of medical insurance, without regard to any life insurance or disability coverage, could leave many families unprotected or underprotected, and vulnerable to economic catastrophe.

Informal polling by some of our steering committee members indicates that there is an inclination among younger and lower-paid employees to respond that they would have to terminate benefits (in order to maintain their present direct compensation) if the employer ceased to provide these fringes. Although NEBI does not propose that these unscientific samplings are representative of all workers' attitudes, certainly they point out certain significant issues which need to be addressed. We must consider the future scenario in the event that employer incentives were eliminated or significantly changed.

For example, let us assume the most drastic case, that all tax incentives to employers were eliminated and Employer X decided to terminate all benefits and retirement programs. Employees would fall into three categories: those who could and would replace critical benefits out of their own resources (for example, through the purchase of high-cost individual coverage); those who financially could, but would not, duplicate the employer-paid benefit coverage; and those who simply could not afford to replace the benefits in any meaningful way. This last group would consist of lower paid workers, persons who because of their age, hazardous occupation or some other factor would be priced out of the health, disability and life insurance markets. Their other more pressing obligations or higher priorities would force them to 'play the odds.'

Inevitably, after enough catastrophies, there would be an increased demand placed upon government assistance programs. Congress would feel compelled to do something to breach the benefit gap. How much of the burden would fall on the employees directly and how much would be left in government's hands is, of course, impossible to state with any certainty. NEBI's member companies anticipate a wide range of responses to elimination of tax incentives. The possibilities range from the institution of some degree of increased employee cost sharing to the complete elimination of some current benefit programs. Although employers recognize a certain moral obligation towards their employees and dependents, this is not enough to offset completely their financial obligation to shareholders. Neither is it sufficient to withstand the pressure from employees who are unwilling to share significantly in benefit cost.

HISTORICAL COALITION FOR SOCIAL PROGRESS

Throughout this testimony, we have made allusions to the important role played by the private sector in the implementation of the nation's social programs. In 1890, only 3.9% of the total population of the United States was 65 years of age or older. That year, 4.3% of the labor force was composed of persons age 65 and older. By 1983, the over 65 age group represented 11.6% of the total population. The projection for the year 2013 is that persons over age 65 will make up 14.7% of the total population. Between the years 1890 and 1976, however, the percentage of the total labor force over age 65 actually declined. Although a law prohibiting mandatory retirement prior to age 70 may have some effect on the number of persons who remain in the work force beyond age 65, it is clear that the present and future prognosis is that the population spread between the younger working segment and older nonworking segment will continue to narrow. Because this group continues to increase in number and percentage of the population, Congress must establish its policy towards the nonworking elderly now.

1. Private employee benefit plans are necessary components in Congressional social programs such as retirement security, health care, educational assistance, employment security and worker's compensation. The Social Security Act of 1935 created the first national program of social insurance, the Federal Old-Age, Survivors, and Disability Insurance (OASDI) program. Social Security was established to be a necessary adjunct to retirement income, whether derived from employer-sponsored retirement plans or personal savings. Although Social Security was not one of the most popular enactments of the New Deal program of President Roosevelt at the start, it quickly gained popularity, and through the next decades additional programs were added to the original retirement program: supplemental security income, Medicare and disability benefits.

The unfunded "pay as you go" Social Security system became increasingly problematic as the number of recipients grew, as the benefits increased and as cost of living increases were mandated by inflation. The enormous costs incurred by this program are carried by current wage earners who are taxed on current earnings. As the percentage gap between workers and retirees narrows and as retirees live longer, this tax rate must grow. A nationwide attitudinal survey towards Social Security prepared for the National Commission on Social Security in 1981 indicates that the public is well aware of the implications of these facts and numbers: 61% of the non-retired respondents expressed doubt that the funds would be available to pay their retirement benefits. Of those between the ages of 25 and 44, almost 75% gave this response.[3] Persons expressing this doubt will certainly resist losing their employer-sponsored, tax-deferred savings and retirement plans. The purpose of this testimony is not to discuss the merits of Social Security, nor to suggest means of reform. Rather, it is

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[3]National Commission on Social Security, A Nationwide Survey of Attitudes Towards Social Security (1981).

intended to show that the public retirement system has been strained due to economic and demographic factors. A "pay as you go" system can be disasterous during periods of high inflation. Increased payments must be made from currently collected dollars. Wage earner tax dollars must be used directly for administrative costs, so that the tax expenditure cost to the government is exacerbated. An adequately funded private system must supplement this "pay as you go" Social Security system.

Social Security was intended to supplement private retirement income sources. Private plans alleviate some of the social and fiscal pressures on government. From the fiscal perspective, private plans reduce government expenditures needed for retirement payments (and provide a pool of investment capital for the national economy). Private plans must be adequately funded, providing additional capital and interest dollars. The interest dollars will help defray the plan's administrative expenses and provide cost of living adjustments as they are needed. Omitting any tax adjustment at payout, the Treasury's eventual recovery may be expressed as follows:

dollars contributed to plan + interest - administrative cost = dollars returned to income stream

From the government's perspective, this dollar cycle compares favorably to the Social Security system. Social Security collects contribution dollars (which are reduced by payments of administrative costs) and almost immediately pays them to the recipient without the intermediate stop in the economy as invested capital. Although this model is simplistic, it demonstrates that the private pension system is beneficial to the economy.

From the social standpoint, private plans play a key role. At the time it was enacted, Social Security was a drastic response to a social and economic crisis. Prior to the Industrial Revolution, a young, agrarian nation could take care of its elderly. Extended families jointly operated farms where the few who survived to old age remained productive in some manner so long as he or she was physically able. The industrialization of America brought about social changes in our work and living habits which could not accommodate the Great Depression.

2. Social Security was not intended to provide universal retirement income. Social Security and private retirement plans are intended to supply retirement income to wage earners. The essential difference between them is that

Social Security was intended as "insurance." Henry L. Bowden, a member of the President's Commission on Pension Policy, commented in 1981, that "[the Social Security system] insures against an inadequate income at the time of retirement. If you have an adequate income at time of retirement, you have not suffered the loss against which you were insured.

Federal policy has been legislatively expressed. There's a commitment to provide the retired with adequate income. Opinions may differ over how much assistance is appropriate and who should pay the bill. Some of the "how much?" questions have been answered by the Congress. The basic Social Security benefit operates within prescribed limits. For the private sector, Congress has established retirement plan contribution and benefit limits. The next question is "who provides?"

Congress had hoped that people would voluntarily save without tax incentives (or, through IRAs, with tax incentives). Because personal savings have not been sufficient to ensure post-retirement security (and because low income persons, who need savings most, have not used IRAs as much as higher income taxpayers), government requires that employers and covered employees make mandatory contributions to Social Security. The private sector employer is induced to do its share with tax incentives. The government necessarily "pays" one way or another for the implementation of its stated policies. Companies, employees and their dependents await your eventual decisions on the future of employee benefits.

3. Tax incentives to employers have encouraged flexibility and innovation in approach and design to accommodate different geographic areas, age and sex groups and employee needs. Let us assume that the government can deliver health, retirement and disability benefits at no greater cost than the private sector. Even at identical price there are sound reasons for delegating some of this responsibility to the employer. The employer is in a better position to respond to the individual needs and demands of its employees. Note that fringe benefits have always been a major subject of collective bargaining agreements.

Our member companies affirm that employees are not passive recipients of benefits. Rather, competitive forces spur the creation of an attractive benefit package which will induce the best possible candidates to choose and remain with a company. While young workers may be less concerned with extensive defined benefit programs, they may be very interested in generous maternity benefits, dental plans and child care assistance. An older population mix may demand retirement security and a savings plan with self-directed investment options. Only a decentralized, market sensitive benefit delivery system can permit such fine tuning. NEBI does not believe that total uniformity is in the country's best interest.

4. Tax incentives to employers have encouraged private sector cooperation in other policy areas. Collecting revenue is only one item on the congressional agenda. The nation has set certain other goals involving quality of life. Education is to be readily available to as broad a segment of the population as possible. Therefore, the government has established low interest loan programs and has historically given employers the incentive to establish their own educational assistance programs.

Quality of life in congested urban areas is another national interest. The government can provide direct aid to local government for mass transportation systems and provide employers with the incentive to set up qualified transportation programs. These plans are beginning to show results. For example, 52% of Atlantic Richfield's employees in traffic-congested Los Angeles are voluntarily participating in a qualified transportation program. Participants are reimbursed for parking costs if they form a car pool of three or more riders. The plan also covers van pools and individual use of public transportation. Such programs are new and have been tried by relatively few employers. NEBI asks this Subcommittee to consider this question: Is the cost through tax loss to the federal government any greater than that occasioned by direct payment of highway assistance or implementation of an air clean-up program? Even an employer-provided lunch program has value beyond employer convenience. It allows some employers to locate in less urbanized areas, perhaps creating needed jobs.

5. Compensation increases in the form of retirement benefits tend to be less inflationary than direct compensation increases. These contributions are properly characterized as savings, and savings do not add fuel to the inflationary flame. The emphasis is on the retirement benefits because some benefits are immediately paid into the economy and are not "saved." Health benefits coverage is the easiest and most obvious example.

Health benefits are intricately tied to the alarming inflationary spiral in health care costs. However, this is one instance where the application of the old maxim "Don't throw out the baby with the bath water" is appropriately repeated. Employers have recently been forced into devoting more and more of their available benefits and compensation dollars to provide the same, or in many cases an inferior, health benefit package. Our member companies, and we believe them to be representative of all employers on this issue, are vigorously working to find solutions to the problem we have described. Employers, who must show profits to their investors, are working to find innovative ways to control health benefits costs. We believe that thousands of employers, working in competition in the marketplace, will discover more ways to save costs than one government-mandated program could ever do. Employers and participants are starting to learn some hard lessons about health care expectations. A punitive tax structure is not the solution. The private sector requests the cooperation of Medicare and Medicaid in finding the proper course.

CONCLUSION

Many member companies have asked themselves a very difficult question: In the event of a major tax incentive overhaul, would they be able to provide the same protection to their employees, or even adequate protection for the present and future health and welfare needs of their employees? Respondents report that it is too early for their companies to actually make decisions, but that they believe that their companies would have to completely eliminate all benefit programs or severely curtail the employer contributions to them.

Congress, business and labor have cooperated for over 50 years in setting up a joint public-private employee benefits system. Before upsetting the balance, the government must consider this complex structure. Congress has listened to business and labor and has been responsive to their needs in this area for many, many years. Look now to the future. We ask this Subcommittee and the full Congress to decide whether the real social and long term revenue costs of tax revenue increases in the employee benefits area will be too high.

Senator PACKWOOD. Mr. Tane, in your judgment, simply because a benefit is tax free, does that mean the company is going to be willing to provide it no matter what the cost?

Mr. TANE. Absolutely not, Senator. Each decision is really made independently and after careful study, looking at the cost and the benefits. The fact that there is a tax incentive for offering the benefit will be a consideration, and in some cases a major consideration. But it does not result in the company automatically offering that benefit. The needs of the employees, the competitive forces, the fiscal ability of the company to provide it, all will be taken into consideration.

Senator PACKWOOD. So taxable or tax free, the employers don't abuse it.

Mr. TANE. Clearly not. They are very concerned about benefit expenses.

Senator PACKWOOD. In that case, why should the Federal Government tax any of the benefits that an employer choose to provide? The employer is going to be wary about providing them because he or she has to pay part of the cost, and the employer and the employee decide between them that this is good for productivity, and good for employee stability.

Mr. TANE. I think I would agree that in general they shouldn't tax it. One of the points that we have seen is that in almost all cases pressure for benefits is for those benefits in addition to the underlying wage. Employees don't view an additional benefit as taking the place of direct compensation. And, therefore, companies have to consider very clearly whether or not it is cost effective for them to offer that.

Again, I think that in most cases the concern is significantly overstated. Most of the companies that we are working with are very concerned about benefit costs and are independently looking at ways to cut those costs.

Senator PACKWOOD. David.

Senator DURENBERGER. Just one question, I guess, probably of Mr. Tane. And the chairman of this subcommittee is much more familiar than I am with this issue. But just for the record, I take it you are familiar with IRS' May 7 regulation or proposed regulation regarding the cafeteria benefit plan.

Mr. TANE. Yes, sir.

Senator DURENBERGER. And it strikes me that forfeiting unused amounts, particularly in the health area, is nonproductive because all the incentives are then to use it up rather than let it be forfeited. And I know one of the proposals that Senator Packwood and Barbara Conable had was to permit that unused portion to be either paid out in cash, used to provide another benefit, or rolled over into a retirement counter into the second year. Would you comment on the appropriateness of our expanding the eligible use of those flexible benefit plans to utilize those kinds of options, and why that would be better, in effect, for the system than the IRS proposal?

Mr. TANE. Yes, sir. There's a very significant problem in the current Tax Code and that is that in most cases that tax incentives for medical care are only there if the benefit is offered as a plan of insurance. And, in effect, the IRS guidelines have said that same thing. There has to be an element of risk.

Well, a lot of recent studies—and probably the most comprehensive is a Rand study—have clearly indicated that when the employee has some financial stake in the health care consumption decision, the employee is a more careful consumer. So what we have is an incentive to create a delivery system that is inconsistent with cost containment. The incentive right now is for a company to provide all the benefits through the insured plan. If the employer wants to create some coinsurance or create some deductible amounts, those amounts, if they were provided by the plan of insurance, would be nontaxable. If the employee has to pay them himself, they are taxable.

So what the reimbursement account does is that it enables a delivery mechanism that does not put a tax penalty on getting the employee involved in the health care consumption decision. And I think that's a very key element, if we are going to do that.

Tax policy can't be at conflict with good health care cost containment principles. So I think allowing some sort of financial reallocation of those amounts back to the individual, being in the form of cash-outs or roll overs, is essential to having a structure that does not provide necessary incentives for employers to provide the coverage in an insured form as opposed to one where the employee gets involved in the decision.

Senator DURENBERGER. Thank you.

Senator PACKWOOD. Gentlemen, we have no further questions. Thank you.

Senator PACKWOOD. Now we will move on to a panel consisting of Boris Auerbach, vice president and secretary, Federated Department Stores, Cincinnati, OH; and Edward E. Burrows, Government Affairs Committee, the American Society of Pension Actuaries, Washington, DC.

Mr. Auerbach, go right ahead.

STATEMENT OF BORIS AUERBACH, VICE PRESIDENT AND SECRETARY, FEDERATED DEPARTMENT STORES, CINCINNATI, OH, AND CHAIRMAN OF THE BOARD, ERISA INDUSTRY COMMITTEE, WASHINGTON, DC

Mr. AUERBACH. Thank you.

I am vice president of Federated. I am chairman of the board of the ERISA Industry Committee, known as ERIC, on whose behalf I am appearing today.

ERIC is made up of over 100 of the Nation's largest employers and sponsors of benefit and retirement security programs for millions of employees.

I think the points we are going to make are going to be in large part repetitious, but I think they should be made. I think these are points that have to be driven home. The strength of our current system cannot be ignored. First of all, the growth of our system of benefits is a result of voluntary action; not Government-mandated compliance. It is a clear example of how a limited measure of tax policy can be translated by the private sector into substantial benefits for working Americans.

Second, as was stressed by one of your earlier panelists, our system is diverse and dynamic. Flexibility is the key. There are differing needs of employees at various stages of their work life—differences in geographical locations, varied resources of employers, different kinds of industries and different makeup of work forces. Government programs can't do this.

Third, the private sector provides a safety net which we believe is far more cost effective and efficient than government programs, which would be necessary to provide similar benefits.

I should also point out that it wasn't until the mid to late 1950's that health retirement and disability programs became a common expectation of American workers. In addition, ERISA's prefunding and 10 year vesting requirements are only a decade old. And over one-half of pension plans currently in operation are less than 10 years old.

As you pointed out in your discussions with Congressman Erlenborn, we keep passing laws and the rate is accelerating at a frightening pace. It is extremely difficult to do the kind of long-term planning that is needed if the rules keep changing.

In addition, Federal budget tax expenditure analysis shows that it is considerably more economic to provide benefits through the private sector. The budget shows that current tax expenditures of over $56 billion for pension contributions and earnings would cost the Government $81 billion. And, as has been pointed out earlier, this ignores the fact that the Government recoups virtually all the current expenditures on present value basis since the taxes are only deferred until a later date.

Employers will not suffer if the changes in tax policy discourage or prohibit prefunding of benefits through tax qualified plans. The employer will receive his tax deduction for benefits paid whether paid out of current income or through a qualified plan. But if changes in tax laws cause the prefunding of benefits to atrophy or disappear, employees, retirees, and their families will be subject to the vacillations of the economy, rather than certainty of prefunded payments. Employers could pay benefits in good years and would be forced to suspend them in bad ones. And unlike today, benefit payments would not survive the employer.

I think I would rather have the funded plans of industry than the huge unfunded problems that we have seen with some government systems such as New York City.

The funds set up by employers create a group coverage for employees that provide benefits at a cost no employee on his own could match. And, indeed, few could afford the same broad coverage at individual policy rates. To abrogate these prefunded benefits will limit their availability, reduce their coverage, and threaten economic security of millions of active and retired workers, their families, and beneficiaries.

In addition, these prefunded benefits provide a major source of investment capital approaching $1 trillion, which I think we should think long and hard about before we change.

I would simply like to leave the committee with two clear thoughts. First, that the present system of employee benefit tax provisions represents a clearly sought out, longstanding, and we believe, rational policy providing economic security for tens of millions of American workers. And, second, if there are going to be substantive changes in tax preferences, please do it slowly, intelligently and not in a rush seeking revenues.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Auerbach follows:]

ERIC

The ERISA Industry Committee

TESTIMONY

Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate

HEARING ON FRINGE BENEFITS
July 26, 27, 30, 1984

for The ERISA Industry Committee
Boris Auerbach, Chairman
July 30, 1984

Mr. Chairman, members of the committee, my name is Boris Auerbach, I am Vice President and Secretary of Federated Department Stores and Chairman of the Board of The ERISA Industry Committee -- known as ERIC -- on whose behalf I am appearing today.

ERIC is made up of over a hundred of the Nation's largest employers and sponsors of benefit and retirement security programs for many millions of employees. Our members comprise a variety of different industries including communications, steel, retailing, automobile, high technology, service, banking, food marketing, oil and chemical, insurance, and manufacturing. Our members are located in every state in the Union.

Mr. Chairman, it is worth noting at the outset, that all of ERIC member companies offer comprehensive employee benefit programs and all of those programs provide benefits to all of their full-time employees, regardless of income level. We are pleased that Senator Packwood has chosen to call these hearings and that he and the subcommittee are dedicating so much time to the issue of employee benefits. We have chosen to limit both our remarks and our written testimony today to the narrow issue of fringe benefits. Clearly other issues also touch on the subject such as proposals to overhaul the present tax system, retirement security programs and other issues. We have chosen to save those issues for another day.

During the last four years there has been a great deal of debate surrounding the maintenance of the government's "safety net" for the truly needy. In addition, much has been made of using the private sector to replace the government wherever possible in its role as provider of benefits and services to the needy. This is as it should be.

It is not without a certain sense of irony, that I appear before you today to defend tax qualified employee benefit programs. For, as surely as food stamps and welfare benefits are safety nets for the needy, employee benefits are the safety net for working Americans throughout our nation.

Mr. Chairman and Senators, it is my task and that of my colleagues in the business community to convince you today that the private sector safety net should not be sacrificed for short-term revenue gain.

No single endeavor of our American economic system so fully responds to human needs as the network of employee benefits provided by American employers. These benefits have not been created in a vacuum. They have evolved through the years as a result of spreading prosperity, a clear government policy favoring their creation and growth, and, in many cases, direct negotiations between labor and management.

Our nation's employee benefits programs are a success story -- not a tax loophole.

Let me begin my defense by outlining the __strengths__ of our current system:

First, the growth of our system of employee benefits is the result of voluntary action, not government mandated compliance. It is a clear example of how a limited measure of tax policy can be translated by the private sector into substantial benefits for working Americans.

Second, our system is diverse and dynamic. It responds to the differing needs of employees at various stages of their work life, differing geographic locations, the varied resources of employers, varying kinds of industries, and the composition of different workforces. Government programs cannot duplicate this diversity.

Third, the private sector safety net is far more cost effective and efficient than government programs which would be necessary to provide similar benefits.

Private sector employee benefits are one of the dazzling sucesses of our economic system:

1. 90% of full time, full year workers now receive health care coverage (1979, current population survey compiled by EBRI).

2. 82% of married couples and 58% of unmarried individuals __will__ receive employer-sponsored pension benefits upon retirement (1982 ACLI study).

The statistics for disability and life insurance are equally compelling.

This is true despite the fact that we are working with a program that has not fully matured. While some aspects of employee benefit programs been supported by tax policy since the late 1920's, both the Depression and World War II conspired to contain their growth. It was not until the mid-to-late 1950's that health, retirement and disability programs became a common expectation of American workers. In addition, ERISA's prefunding and ten-year vesting requirements are only a decade old and over one-half of pension plans currently in operation are less than ten years old.

The statistics of success which I cited earlier are premised upon continued government support for employer-sponsored, prefunded employee benefit programs. Continuance of employee benefits requires the ability by sponsors to make long-term decisions based on stable government policy. Employers must make decisions today on benefit levels to be provided 20 or 30 years from now. The great population bulge represented by the postwar baby boom now fills the ranks of the American labor force -- and will within a few decades be at the door of our nation's retirement programs.

The federal budget tax expenditure analysis clearly indicates the economy of providing benefits through the private sector. Even though the budget shows a current tax expenditure of over $56 billion for pension contributions and earnings, estimates in the budget of what it would cost the government to provide those benefits is $81 billion. Moreover, these tax expenditure numbers ignore the fact that the government recoups virtually all of the current expenditure on a present value basis since the taxes are only deferred until a later date.*

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* Taxes are collected in the future both on the amount of the original deferral plus income earned on investments at the time these amounts are paid out to individuals in the form of benefits.

FY 1985. But, according to the budget, it would cost over $28 billion to provide that protection through the government. In the case of each benefit "expenditure", estimates show the private route to a better deal <u>for the government</u>.

Employers will not suffer if changes in tax policy discourage or prohibit prefunding of benefits through tax qualified plans. The employer will receive a tax deduction for benefits paid whether they are paid out of current income or through a qualified plan.

But if changes in tax policy cause prefunded benefits to atrophy or disappear, employees, retirees and their families will be subject to the vacillations of the economy rather than the certainty of prefunded payment. Employers could pay benefits in good years but would be forced to suspend them in bad ones. And, unlike today, benefit payments would not survive the employer. We would return to the very problems which led the Congress ten years ago to enact ERISA.

In addition, a tax policy which prohibits or discourages prefunding pushes employers further from tax qualified plans and their anti-discrimination tests.

The funds set up by employers create a group coverage for employees that provides benefits at a cost that no employee on his own could match. Indeed few could afford the same broad coverage at individual policy rates. To abrogate these prefunded benefits will limit their availability, reduce their coverage, and threaten the economic security of millions of active and retired workers, their families and their beneficiaries.

Prefunded retirement and welfare benefits provide a major source of investment capital approaching one trillion dollars. Clearly, this pool of private investment resource will be severely depleted if we change long-standing social policy which recognizes the tax preferred status of employee benefit programs.

As government makes its choices in the name of deficit reduction, it must consider whether its needs for revenue take precedence over the needs of employees and private investment. It is not a judgment to be made lightly.

The point is often made that Medicare, unemployment, disability and other government provided income security programs are a necessary underpinning for the private sector. What gets overlooked is the opposite point: private sector employee benefit programs are equally necessary to the success of these important government protections.

The pressures on Social Security to increase benefits would be enormous today if many people did not also have private pensions to help maintain their standard of living. The pressures on future benefits for social security would be prohibitively expensive when the baby boom generation retires if private plans were to diminish. Private sector disability, unemployment insurance, life insurance and other benefits clearly meet social needs which would otherwise be pountding at the door of government.

Nowhere is this more obvious today than in the field of health care, where a large portion of money saved recently in the Medicare system has consisted of shifting costs formerly borne by Medicare to private sector health care through first payor requirements, co-payments, deductibles, and so forth. If the private sector had not been there to take up the slack and to find innovative ways to reduce health care costs, each Member here knows that the personal suffering -- not to mention the public outcry -- involved in these Medicare cutbacks could well have made them prohibitive.

Private employee benefit programs are not set in stone. They are creatures of social and tax policy, the growth of our economy, the desire of the private sector to retain productive employees, demands of workers themselves, and many other reasons that vary from employer to employer, employee to employee, region to region and industry to industry.

The favorable tax policy and legislative support accorded to various employee benefit programs should not be reduced. We have a dynamic, diverse, successful system providing benefits to tens of millions of American workers. We cannot afford to be short-sighted.

I would like to leave the Subcommittee with two clear imperatives: first, that the present system of employee benefit tax provisions represents a clearly thought out, long-standing, rational policy of providing for the economic security of tens of millions of American active and retired workers; and second, that if there are to be substantive changes in tax preferences, whether by way of deficit reduction, tax equity, a flat tax or some other system of taxation, Congress must face up to the question of how that new system will affect the income, health, and retirement security of active and retired employees, their families, and their beneficiaries.

Not to do so will imperil the security of many millions of people who now rely on and make long-term plans on that existing system.

STATEMENT OF EDWARD E. BURROWS, GOVERNMENT AFFAIRS COMMITTEE, THE AMERICAN SOCIETY OF PENSION ACTUARIES, WASHINGTON, DC

Senator PACKWOOD. Mr. Burrows.

Mr. BURROWS. Thank you, Mr. Chairman.

I'm speaking on behalf of ASPA, the American Society of Pension Actuaries. ASPA is a national professional society with about 2,000 members. Our members provide actuarial and administrative service to a large number of employee benefit plans. These include about 30 percent of all private retirement plans in the country.

The principal thrust of our written statement is that employee benefit legislation has suffered from an absence of national policy and objectives. We believe it's time to back up a step and do some long-term planning.

First, before deciding how much of the job belongs to Social Security and how much to the private sector, we suggest defining the job. This will include a consensus on amounts of benefits, when protection should begin, and how we should handle inflation. In defining the job, it's important that we sort things out by cause of need and not by plan or type of plan.

The list includes these causes: Death, disability, medical care, living a long time, education, homeownership, unemployment.

Let me give an example of our failure to analyze by cause. ERISA has mandated for many retirement plans, a preretirement spousal survivor benefit. This benefit is complex to administer, difficult to understand, and to be quite honest, not worth very much. The Pension Equity Act is about to be born. It promises to make this requirement even more complicated. Through all of this, nobody has asked what other sources of death benefits there might be. What is the plan sponsor doing about group life insurance? Should the ERISA preretirement survivor requirement reflect the employer's group life plan? Arguably, it should.

Now after we have decided what the job is, we will need to ask how much of it the private sector should be performing. And here I suggest we ask not whether we are providing too much incentive, but instead whether we are providing enough. Without nearly universal private plan coverage, we are going to continue to take heat on further Social Security and medicare expansion. We have got to find ways to take those employers who don't sponsor adequate plans and make them an offer they simply cannot refuse.

The tax expenditure to do this will be far less than the cost of expanding Social Security.

Finally, with the job defined and the role of the private sector defined, we can sit down and do some legislating. We should follow our game plan religiously. We should keep it simple. And most importantly, we should be sure we have got the private sector into the act.

ASPA, for its part, wants to be in the act. We want to help wherever we can be helpful.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Burrows follows:]

HEARING ON FRINGE BENEFITS

Statement by:
American Society of Pension Actuaries

To:
Subcommittee on Taxation and Debt Management
of
Senate Committee on Finance

STATEMENT ON FRINGE BENEFITS
BY
AMERICAN SOCIETY OF PENSION ACTUARIES
TO
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE COMMITTEE ON FINANCE

INTRODUCTION

The American Society of Pension Actuaries welcomes this opportunity to submit its statement in connection with the hearing on fringe benefits conducted by the Subcommittee on Taxation and Debt Management of the United States Senate Committee on Finance.

The American Society of Pension Actuaries (ASPA) is a national professional society, whose 2,000 members provide actuarial consulting and administrative services to a large number of employee benefit plans. These include approximately 30% of all private retirement plans. The subject matter of the subcommittee hearing is of great concern to our members.

We are restricting our statement to the question of retirement income. In this area, we are devoting most of our attention to the need for reaching a broad consensus on goals before any further legislation is attempted. In our view, there has been entirely too much legislative tinkering and entirely too little attention to long-term objectives.

In this statement, we suggest that the first step is to formalize retirement income goals for the nation as a whole. Then, policy should be established on the relative roles of government, private employers, and individual workers in meeting these goals.

After policy is formulated on both of these questions - goals and roles - it will become possible to develop intelligent legislation. This legislation will cover both requirements and incentives for private plans.

In our belief, it has been harmful and debilitating for so much legislation to have been enacted without benefit of this long-term policy planning.

Since enactment of ERISA, employee benefit legislation has become almost an annual affair. Each round of legislation introduces a round of regulation writing. Quite frequently, plans will have to be amended to accommodate legislation and then re-amended to accommodate the regulations precipitated by the legislation. During 1984 and 1985, almost every defined benefit plan in the country will have to be completely restated to comply with the 1982 Tax Act (TEFRA). These same plans will have to be further amended to satisfy additional requirements of the 1984 Tax Reform Act, the 1984 Pension Equity Act, Early Plan Termination Regulations promulgated in January 1984 as a result of ERISA, and Revenue Ruling 79-90 promulgated five years ago. And, this list assumes no further legislative or regulatory activity.

The process of legislation without long-term direction is vividly illustrated by the tinkering which has taken place relative to the rules on retirement plan distributions (Section 401(a)(9) of the Internal Revenue Code). TEFRA drastically amended these rules. As a result, some plans have already been amended. Others are in various stages of the amendment process. The Internal Revenue Service has drafted suggested language for use in master and prototype plans. All of this has taken place at considerable cost to taxpayers. Now, with the ink still wet on the TEFRA compliance amendments, Section 401(a)(9) has been changed completely by the 1984 Tax Reform Act.

In identifying areas for policy planning, we also suggest, in broad terms, the policy decisions which might emerge. We do not mean to imply that these are the only possible decisions. In our view, it is critical that there be rational long-term planning. The exact details of the decisions are less critical, provided these decisions are based on an informed consensus.

ASSUMPTIONS

In order to restrict our remarks to a manageable length, we are stating certain assumptions without developing them completely. In some cases, we believe the appropriateness of these assumptions will be self evident. In others, we believe there will be ample treatment through testimony received by the subcommittee from other sources. Nevertheless, we shall be happy to supply additional material relative to any of these assumptions, if desired.

These are the assumptions we have made:

1. Our society will continue to insist that its older citizens be permitted to live in dignity, comfort, and self-respect after retirement.

2. Individuals will not generally make their own provision for retirement through voluntary savings unless given powerful incentives offering current rewards.

3. To a great extent, the resources necessary to provide retirement income for any single generation should be provided through that generation's economic output. Intergenerational transfer arrangements, such as the current social security system, need not be eliminated, but should be de-emphasized.

4. Even if we were starting from scratch, it would not be desirable that the whole task of providing retirement income be handled through the public sector. The public sector would not do the job with the degree of administrative efficiency likely to be achieved by private enterprise. Furthermore, the overall arrangement should make allowances for regional and cultural differences in workers' needs. Allowances for these differences would prove difficult in a totally public program.

5. The current interaction of public and private programs has experienced a significant degree of success. It would be a disorderly and costly setback to scrap this current interactive approach in favor of an all-public arrangement.

6. It is not desirable that private sector involvement be placed on a mandatory universal basis. There are private enterprises which are marginal in terms of ability to survive. In some cases, this marginal status is temporary, in others it may continue indefinitely. In both cases, these marginal enterprises play a positive role in our economy. However, they are not well equipped to shoulder their share of an expanded mandatory retirement income program.

7. If powerful incentives offering current rewards are to be utilized, it is more desirable to format the incentives as tax expenditures than as direct cash subsidies.

8. When balancing costs and benefits, a tax expenditure should not be measured as current year revenue losses minus current year revenue gains. Instead, it should be measured as current and future revenue losses attributable to this year's active workers minus future revenue gains attributable to these same workers. In performing this calculation, appropriate adjustments should be made for the time value of money.

GOALS FOR RETIREMENT INCOME

We believe reaching a consensus on the nation's retirement income goals will be aided if the task is approached with four questions:

- In relation to active wages, how much retirement income should be provided?
- At what age should retirement occur?
- Should retirement be a sudden and complete step, or should it be gradual and, in some cases, partial?
- How should the problem of inflation after retirement be handled?

We treat each question separately.

AMOUNT OF RETIREMENT INCOME

When retirement income is expressed as a percentage of wages immediately before retirement, the percentage is usually described as a replacement ratio.

It seems likely that a consensus on our goal for replacement ratios will come fairly easily. This consensus will be that we should try to permit the worker to maintain a standard of living after retirement which is the same as his pre-retirement standard.

This does not mean our goal should be a replacement ratio of 100%.

A number of costs diminish sometime around the point of retirement:

- Housing costs are lower, once the children have grown, and smaller accommodations have become preferable.

- Child-rearing costs - particularly the costs of education - have ceased.

- Work-related costs have ceased. These costs include transportation, clothing, and meals at the workplace.

The personal savings flow is reversed:

- Home mortgage payments cease, and home equity becomes available to finance retirement living.

- Other personal savings plans follow similar reverses.

Taxes go down:

- Age exemptions become available.

- Some cash receipts, such as savings withdrawals and some social security benefits, are tax free.

- Payroll taxes, such as the social security tax, are eliminated.

Some costs, notably medical expenses, go up.

It seems likely that a consensus will place the desired replacement ratio somewhere around 65% for "Middle America." It will need to be higher for workers at the lower end of the spectrum. It can certainly be lower for those at the upper end.

RETIREMENT AGE

We believe it is time to question the sanctity of age 65 as our target retirement age.

This sanctity was questioned successfully with the 1983 social security amendments. Under social security, the target age is now scheduled to increase gradually until it reaches 67 for workers born after 1959. ERISA rules continue to treat 65 as sacred. Our failure to maintain correlation between private plan rules and social security is just one example of our failure to establish and follow a long-term plan.

It is statistically defensible to predict age 65 life expectancies which will have increased by 25% during the 50 years ending in 1990. Consider these life expectancies for 65 year-old males, taken from Actuarial Study Number 92 of the Social Security Administration, using alternative II:

Calendar Year	Life Expectancy (Years)
1940	11.9
1960	12.9
1980	14.0
1990	15.1 (est.)

With our headway against chronic diseases gaining momentum, we are making advances in healthy life expectancies, as well. This means that in the years to come, we shall probably be living longer and staying healthy longer.

If we adhered to age 65 as the target age, we would soon reach the point where 25% of our population is on the retirement roles. We have a great many social needs competing for our resources. It seems questionable whether supporting this 25% ratio reflects a sensible allocation of these resources.

Perhaps the rules covering private plan retirement ages should be brought very quickly into line with the 1983 social security definitions. Then a means might be sought by which both social security and private plan rules will be subject to future automatic adjustments. These automatic adjustments would be designed to keep in line with changes in life expectancies and healthy life expectancies.

It might be well if this adjustment process were removed from the political arena. This could be accomplished by relating automatic statutory adjustments in normal retirement ages to changes in objectively measurable longevity statistics.

Just to illustrate the potential magnitude of these future adjustments, it does not seem unrealistic to predict that 75 years from now, age 78 will have the same meaning that age 65 has today.

PHASED RETIREMENT

At present, our rules are geared to the concept that a worker is either active or retired - nothing in-between.

Anyone who has worked with retirees, or employees about to retire, can testify to the trauma of cliff retirement. It is not healthy to be fully active one day and fully retired the next.

Cliff retirement is not particularly healthy for the active employees left behind, either. If the retiree had been pulling his weight, his sudden departure means very difficult work reassignment problems the day after retirement day.

And finally, it may not be a good allocation of national resources to force total non-productivity upon a worker who might prefer to be partially productive.

Our rules might be structured to encourage gradual retirement.

INFLATION PROTECTION

It would be a mistake to define a national policy on retirement income without addressing the question of inflation after retirement.

Certain public plans - notably social security - incorporate automatic inflation protection. Sometimes these automatic features seem to go too far. This is the case, for example, when retirees are totally insulated from the impact of rising fuel costs or rising health care costs. In the case of social security, we have paid dearly for this total insulation. Over the last ten years, indexation has increased program costs by more than 30%. With some types of rising costs, the right answer probably is not to insulate, but to rethink our priorities on resource allocation.

Private plans have gone to the other extreme. It is a rare plan which automatically adjusts for inflation after retirement (although ad hoc increases are quite common).

At ASPA, we have mixed feelings respecting automatic adjustments. On one hand, we believe it would be a mistake to index everything in our economy to inflation. This could lull us all into believing that inflation is no longer a problem requiring containment.

On the other hand, we must acknowledge that retired workers on fixed pensions are more vulnerable to the ravages of inflation than any other group in our society. It may be that an element of automatic protection should be part of our national policy. To the extent we do employ indices, we must be sure they reflect the facts. Inflation in pension costs and inflation reflected by generalized indices, such as the BLS Consumer Price Index, are not necessarily the same.

MEETING OUR GOALS

With the nation's goals firmly defined, it will become appropriate to define the roles to be played by social security, private plans, and individual worker savings.

UNIVERSAL PRIVATE COVERAGE

It will be recalled as one of our assumptions that intergenerational transfer programs such as social security should be de-emphasized. Another is that the job should not be handled entirely through the public sector. Still another is that private plan coverage should not be mandatory.

But, there can be no meaningful role for private plans unless their coverage is virtually universal.

In order to make private plan coverage virtually universal, we must make those employers not now sponsoring plans an offer they cannot refuse. There are those who say that tax expenditures on behalf of private retirement plans are too great. We suggest that in some respects, these expenditures are not great enough.

We believe the payoff of nearly universal private coverage will far exceed the cost of the additional incentives. This payoff comes in two broad measures.

The first measure is reduced pressure on social security. If there is no significant class of worker unprotected by private plans, social security can gradually fall back to the level originally intended for it. We believe social security should be viewed as a safety net just adequate to insure that no citizen need live in poverty. This would bring to fruition the hope expressed by Labor Secretary Donovan in announcing formation of the National Pension Forum. In his June 14, 1984 news release, Donovan stated "The private retirement system will rival the social security system in the benefits provided to future retirees."

This social security rollback should not happen overnight. It will be a long gradual process. Each of us has a contract with the social security system. The system should not be permitted to back off on the portion of this contract based on years already worked. To permit this would be no fairer than to permit cutting back a pension accrued under a private plan.

The other large measure of payoff involves the redesign possibilities for private plans already in existence.

At present, the private plan generates a "target" or "optimum" benefit level for any worker who retires after, typically, 25 years or more. There is no law telling a plan sponsor it has to be this way. But, as things stand now, the sponsor knows that a high percentage of his new employees will not be bringing vested pensions with them. So, if the employee who retires after 25 years with the sponsor is to have an adequate private pension, it must come from the sponsor's plan.

Suppose the sponsor knows that a new employee who has ever worked anywhere else already owns a vested benefit. Now, the sponsor need only feel responsible for that portion of the worker's career spent with the sponsor.

Suppose the sponsor had previously been one of those who had established 25 as the required number of years for a maximum benefit. The sponsor might now increase the number 25 - perhaps to 46. This might reflect the period from age 21 to age 67.

The result would be a substantial reduction in yearly pension credits under the sponsor's plan for employees who retire after 25 years or less. The new yearly credit would be just 25/46ths, or 54% of the old. This is a reduction in benefits,(and costs) of 46%. In general, the employee is not hurt. Whatever is no longer provided by the sponsor who had always maintained a plan will now be provided by the employers who accept our "offer they cannot refuse." The original sponsor might find that after this cost reduction, there is money enough to finance such things as inflation protection.

The approach does exacerbate one problem. This is the problem of the homemaker, whose adult lifetime is spent largely working for compensation not measured in dollars.

The homemaker typically works for pay for a brief period, leaves the labor market to manage the home for several years, and finally returns to the labor market. It is often asserted that because of the homemaker's situation, pension credits should be required to build up quickly, early in a worker's period of employment. This reasoning underlies the ten-year build-up requirement of the TEFRA top-heavy minimum accrued benefit provisions.

In setting national policy, we must be careful not to solve the homemaker's problem in a way which forces overkill for employees who are not homemakers. In the last analysis, a better solution to the homemaker's problem is probably a more aggressive approach to rules on spousal income splitting.

The additional tax incentive, the "offer they cannot refuse," might take the form of a tax credit related to annual plan costs. It might be temporary, with penalties for early plan termination. Alternatively, it might be an annual arrangement which continues indefinitely. Any such indefinite arrangement might be cast so that it has relatively little impact on the larger or more successful employer who already has incentive enough.

THE ROLE OF SOCIAL SECURITY

As already discussed, social security might gradually recede to the point where it is just adequate to protect against poverty.

THE ROLE OF THE PRIVATE PLAN

Different workers at the same wage level need different replacement levels to sustain their pre-retirement living standards. This means that for any wage level, there is a spectrum of target replacement ratios.

In defining the role of the private plan, we might select replacement ratios from the low end of the spectrum. These low-end ratios might range from 80% for the lowest paid worker, to 65% for the middle income earner, and perhaps 50% for the upper-income person.

The optimum commitment of the private plan might be determined using this formula:

- Multiply the low-end replacement ratio by the worker's final pre-retirement annual wage.
- Subtract social security.
- Subtract the yield from the minimum reasonable personal savings expected of the worker.
- The balance would be the private plan's optimal commitment.

We propose this formula as an analytical tool to help frame the nation's goals. We do not propose it as a formula to be required, or even recommended, for incorporation into individual pension plan documents.

THE ROLE OF INDIVIDUAL SAVINGS

One often hears that in today's world, the average American is unable to amass any significant personal savings.

For the lowest earner, this assertion is true enough.

For Middle America, it is demonstrably not true. A great many middle-income workers approach retirement with, if nothing else, significant home equity. This home ownership phenomenon might furnish useful guidance in defining minimum reasonable personal savings.

Suppose, for example, it were concluded that the typical middle income worker reaches retirement with home equity equal to 200% of wages immediately before retirement. Our national policy planning might include development of a curve showing minimum reasonable personal savings as a percentage of wages immediately before retirement. This curve might start at zero for the lowest earner, increase to 200% for the middle earner, and increase to higher percentages for higher income workers. This curve would not appear in any statute. It is proposed, simply, as another analytical tool.

Any worker who needs more than the minimum replacement ratio might reasonably be expected to provide the extra through his own initiative. This would be in addition to the minimum reasonable personal savings expected of everyone.

LEGISLATING THE PRIVATE PLAN REQUIREMENTS

ONLY AFTER LONG-TERM POLICY HAS BEEN DEFINED WILL IT BE POSSIBLE TO FORMULATE RATIONAL LEGISLATIVE REQUIREMENTS FOR PRIVATE RETIREMENT PLANS.

Once that point has been reached, we believe there are a number of guidelines which would help insure success of the legislative effort.

1. FOLLOW NATIONAL POLICY RIGOROUSLY AND EXPLICITLY

Every proposed requirement should be analyzed with this question: Does the proposal move explicitly in the direction of satisfying national policy?

This guideline is best illustrated by a recital of some of our failures.

First, consider our current rules on integration of private plans with social security. If these rules help arrive at rational replacement ratios, it is strictly by accident. The rules start off by making an arbitrary and indefensible distinction between employer-financed and employee-financed social security benefits. In a mandatory program such as social security, no purpose is served in making this distinction.

Then the rules go on to define certain very arbitrary ratios between primary benefits and total benefits.

It would be far more sensible to say that our goal is to satisfy certain replacement ratios, which we have specified. In deciding how much of the goal we hope to achieve through the private plan, we shall subtract, dollar for dollar, the portion achieved through social security.

Integration of public and private retirement programs is essential if we are to satisfy rational goals rationally. The weakness of existing integration rules must not be accepted as "proof" that social security integration is bad and should be forbidden. We are saying, instead, that with a goals-oriented approach, the rules would read differently and more sensibly.

Second, consider the minimum accrued benefit requirement for non-key employees in a top-heavy plan. The entire minimum is accrued in ten years. Suppose a worker has participated in four different plans sponsored by four different employers. Suppose he participated for 10 years in each. In the absence of inflation and improved productivity, he would walk away with a replacement ratio equal to 80% of pay. This would be just from the private plans. Social security would be extra. If each of the four employers wished to enjoy the same limitations on benefits and contributions automatically available in non-top-heavy plans, the 80% figure would increase to 120%.

It is difficult to imagine a national policy served explicitly by these provisions. Inflation is a fact of life not likely to disappear in the near future. This makes our 80% scenario improbable. Nevertheless, the TEFRA minimum is conspicuous as a rule which will produce overkill for some workers, and probably shortfall for others.

Third, consider the discrepancy between rules for top-heavy plans and rules for those which are not top-heavy. Is it a matter of national policy that employees in top-heavy plans will enjoy protection unavailable to employees in non-top-heavy ones? Clearly it is not. Have we taken this action because we thought our tax expenditures are greater for top-heavy plans as a class than for non-top-heavy ones? Clearly the reverse is true. Indeed, this irrational and inequitable discrepancy is even now sapping the vitality of the voluntary private pension system.

2. PROVIDE TAX INCENTIVES PROPORTIONATE TO AN EMPLOYER'S WILLINGNESS TO MEET NATIONAL GOALS

It seems almost axiomatic that employers willing to go part way towards meeting national policy should receive some tax incentive. Employers willing to go further should receive more.

The permitted pre-TEFRA approach to "social security excess plans" violated this rule. It provided tax expenditures for employers who, in some cases, did nothing for their rank and file employees.

TEFRA top-heavy rules for defined benefit plans are just as far off the mark in the other direction. They tell the employer he is free to do nothing or free to provide the full mandatory TEFRA top-heavy minimum - nothing in-between.

We should be telling every employer we have a goal for private plans. Every employer is free to go as far as he wishes towards this goal. But, he must go at least as far with his rank-and-file employees as he does with his key people.

3. ENCOURAGE CONSTRUCTIVE PRIVATE SECTOR PARTICIPATION IN RULE MAKING

Some of the private plan requirements which will inevitably result from a goals-oriented approach will be difficult for the private sector to accept.

For example, many observers feel that national goals are not compatible with anything less than full, immediate vesting. The jump to full immediate vesting will be much less costly than most plan sponsors realize. However, the issue is charged with emotion. It is a subject which requires, when discussed, diplomacy and educational effort.

Diplomacy, openness, statesmanship, and the encouragement of constructive private sector participation have not been the most prominent characteristics of tax law writing in recent years. Probably, the nadir was reached with TEFRA, where many of the retirement income provisions were incorporated without benefit of public hearings.

If mutual trust can replace mutual distrust, a more soundly conceived approach to retirement income will result.

It will probably be necessary to explore requirements which are even more troublesome to the private sector than mandatory immediate vesting. For example, it seems inevitable that pre-retirement cost-of-living indexation of vested benefits will have to be examined. The question of post-retirement cost-of-living indexation will also require attention.

These are all sensitive areas. Extreme and intractable initial postures must be avoided if we are to achieve satisfactory results.

Of course, once invited to participate in a constructive way, it will be up to the private sector to accept the invitation. ASPA, for one, pledges to participate in every way possible.

4. WORK TOWARDS A MORE SALUBRIOUS CLIMATE FOR DEFINED BENEFIT PLANS

As national policy develops, it is likely to include many objectives more easily satisfied by defined benefits than by defined contributions.

The two most obvious examples are inflation protection and individually tailored, phased retirement. There are many other examples where objectives can be satisfied only approximately with defined contributions, but precisely with defined benefits. Precision means doing enough without engaging in overkill. Hence, precision reflects a more efficient use of our resources.

Consider the most obvious point of all. Retirement income, to be effective, must continue throughout the worker's retired lifetime. This lifetime guarantee is impossible to achieve in a defined contribution plan without turning to an insurance company. We believe it might be desirable for national retirement income policy to be neutral on the question of encouraging or discouraging the use of insurance company products.

5. ENCOURAGE SIMPLICITY AND STABILITY

In retirement plan legislation, the private sector has managed to create for itself the unenviable image of being against all change. One reason for this posture is the rapidity with which change has been emanating from the legislators. Plan sponsors are bewildered. Plan participants are bewildered. Practitioners are, of necessity, demanding ever increasing fees just to keep up with the changes. In our introduction, we recited the changes defined benefit sponsors will be required to make just in 1984 and 1985.

Administrative complexity has emerged as a related problem. Consider, for example, the inter-relation of Sections 415(e) and 416(h) of the Internal Revenue Code. Whatever one might say for or against the objectives, the results are monstrous.

We see a need for much more involvement in the legislative process by those responsible for plan administration. These are the people with the experience to think through a proposal from the standpoint of its potential administration problems. Towards this end, ASPA, with its 2,000 active practitioners, stands ready and eager to contribute.

CONCLUSION

The rallying cry, today, is deficit reduction. This makes every tax expenditure guilty until proven innocent.

We believe intelligently conceived tax expenditures, designed to encourage effective private retirement plans, will help rather than hurt the federal budget.

An effective private retirement system will clear the way for a de-emphasis of social security. This de-emphasis could have a profound and positive effect on the federal fiscal scales. This positive effect could far outweigh any perceived negative effects of tax expenditures to encourage private plans.

The only requirements are that the expenditures be cost effective, and that they not favor any segment of our citizenry over any other. We believe both of these criteria can be achieved through careful and intelligent planning.

We view formation of the National Pension Forum as a promising first step in this process.

ASPA wishes to help in any way the subcommittee might find useful.

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This statement is respectfully submitted on behalf of the American Society of Pension Actuaries by its Government Affairs Committee.

July 25, 1984

E. ward E. Burrows, M.S.P.A
ommittee Member

Senator PACKWOOD. You are right about Social Security. Government, if it wants, can just mandate employers to provide coverage, not unlike workers comp or unemployment comp. We could do that as an alternative to Social Security increases and say the employers will make up the difference. I would prefer to get there voluntarily through tax incentives rather than legal coercion.

As you look down the road, I can foresee exactly what you are suggesting possibly happening. I have never been able to get an accurate cost, because I'm not sure there is a way to do it, of what it would cost the Federal Government to provide the equivalent health coverage through national health insurance that we now basically get through employer-paid health plans. Weighing that cost against the alleged tax expenditure, because the premiums are not taxable would be hard to get a comparison.

Medicaid and medicare, are two unique groups where probably you have got higher medical expenses than would be similar for other people of similar ages.

I'm willing to bet, had we not had health insurance over the years, we would now have national health insurance. The demand would have been there. We would have a system not unlike the Scandinavian systems or the British systems that would cost employers more for worse coverage than we now get.

Mr. BURROWS. Indeed, we would.

Senator PACKWOOD. I would also be willing to bet that if 20 or 30 or 40 years ago employers began to provide health coverage for their retired employees, we never would have gotten into medicare. But they didn't, and we did and we are not going to back off of that now. But I would be willing to bet that would have been the outcome.

Dave?

Senator DURENBERGER. Thank you, Mr. Chairman.

I probably should save this comment for later, but it keeps coming up and you have just reiterated it. And that is that Government is bad and business is good. One of the sentences in Mr. Auerbach's statement is typical. It says:

> The private sector disability, unemployment insurance, life insurance and other benefits clearly meet social needs which would otherwise be pounding at the door of government.

Now in sort of a political historical perspective—if you went back into the sixties and the seventies, it sure looks like that. Mr. Burrows points out that this is the time to sort of look back and get equal credit for the demise of some of these systems on both sides.

Now I was just handed by a previous witness a response to a question that was raised last week about first dollar coverage. And let me preface my comment by saying that when I go around having health care hearings on reforms in medicare, which we instituted—it wasn't Government that told us to institute it or business that told us to institute it—the doctors always come up and blame everything on 1965 and the medicare-medicaid program. And I take them back to 1954 when we changed the Tax Code to try to facilitate what a lot of good businesses were doing. That is implementing this relationship between employers and employees.

Well, the response to this question on first dollar coverage is, with pride, business has decreased first dollar coverage from 36 percent of the companies surveyed in 1980 down to 7 percent. Now that is really terrific. But look what you all did to the health care system in America with first dollar coverage from the period 1954 or 1965 up to 1980. You brought in the dentists, who are going to testify later, and mental health and a whole lot of things we needed in these systems. But you gave them away in effect. You destroyed the concept of health insurance. The idea that people ought to be involved in making some of these choices. And they ought to be put partially at financial risk in making those choices.

So I make this little speech not in preface to a question, but to make sure that if we are going to make good long-range policy that we all recognize that business left on its own doesn't do much better of a job than Government does. And by its past record.

And I am still committed, as Bob is, to doing a lot of these things in the private sector. But when it comes to your next statement, Mr. Auerbach, using health care as an example—if you hadn't had the third party backup, we wouldn't have been able to shift medicare cuts. That is absolutely true. But then don't claim that it was businesses finding innovative ways to reduce health care costs that alleviated all this personal suffering.

I will take you to Arizona and Massachusetts and a lot of States where business is using Government. Now you can give me a lot of the other examples and I will credit you. But business is using Government to bring State rate setting and franchising of this whole incompetent hospital care delivery system and a lot of business people don't understand the value of giving their employees choices and what that choice could do to turn this system around.

So that is all my frustration. I have shared it with everybody, and I won't have to repeat it during the course of the day. But if we are going to do this right—and you guys are absolutely right. The chairman is absolutely right. It's patience with me and everybody else in going through this long list of witnesses in this hearing. If we are going to do it right, we are all going to have to recognize, one, it isn't easy; two, the system of income security and health is very complicated; three, that Government isn't necessarily bad, business isn't necessarily bad, but we both have to find that sort of partnership utilizing in part the Tax Code and in part other things to get the job done.

And I didn't want to sit here the rest of the day and have a long list of business witnesses coming and repeating this line about Government will screw it up and we are all OK out there. Thank you for letting me.

Senator PACKWOOD. Don't paraphrase me too much, Dave. All I am saying is Government is a bad manager, we are not bad at setting goals. It's when we try to actually manage things ourself. If we think we can teach better than Catholic University, if we think we can administer health better than Blue Cross, fine. Let's socialize it all and we will see how we do. But my hunch is that it will cost us more for less. Setting goals is another matter. When we say to business or to education or to somebody else you must teach the following, that is what Government ought to do. We shouldn't try to do it ourselves too often.

Senator DURENBERGER. And my only response to that is that we set broad goals like accessibility and quality in the system, but then we ought to rely on the private sector and individual choice in all of these areas—pensions, health care, child care, or whatever. And this is a good message for unions and everybody else. Rely on those folks out there. They make a heck of a lot better choice than we do as an employer on their behalf, and, certainly, that we, as Government, as an insurer of this system.

Senator PACKWOOD. George?

Senator MITCHELL. I have no questions.

Senator PACKWOOD. Gentlemen, thank you very much.

Senator Packwood Now we will move on to a panel of Harry Garber, vice chairman of the board, the Equitable Life Assurance Society of the United States; and Carl Sardegna, executive vice president, Union Mutual Life Insurance of Portland, ME.

Mr. Garber, why don't you go right ahead.

STATEMENT OF HARRY GARBER, VICE CHAIRMAN OF THE BOARD, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, WASHINGTON, DC

Mr. GARBER. All right. Mr. Chairman, Senator Durenberger, Senator Mitchell, I appreciate the opportunity to appear before the subcommittee today to present Equitable's views on the important issues that you have identified. These questions are important to us not only because we are an insurer for such plans but because we are an employer and sponsor of benefit plans covering some 30,000 employees.

What I will try and do today is talk about some of broad concepts that we have applied in the development of our plans, with some specific examples, and then go a little bit into some of the problems of changing the tax structure and benefit plans.

To give you a sense of the dollars involved, Equitable benefit plans paid to active and retired employees and agents and their beneficiaries $34 million in retirement benefits, more than $8 million in disability income, $41 million for hospital and medical care benefits and $9 million in death benefits. We hold funds for the payment of future payments under retirement plans of about three-quarters of a billion dollars. This is for our own employees and agents.

Our philosophy is to seek to maintain an integrated set of plans which will provide financial protection against illness, disability, death, and old age sufficient to avoid a material reduction in the standard of living of the employee and his family. The value of these benefits transcends their economic costs. With this protection our employees have happier personal lives and are more productive on the job. We think good human relations is good business in this respect.

The maintenance of an economic security net requires periodic reviews and changes in benefit plan structure. I have three examples here. The first deals with retirement benefits where the rampant inflation of postwar era has made it quite clear that pension plans based on career average earnings will often produce inadequate retirement benefits.

In response, Equitable has its retirement benefits based on the average salary during the last 5 years, and this practice is now widespread in industry. Further, to protect against inflation in retirement we have, since 1969, explicitly indexed the benefits to the CPI, with limits. It's not full indexing. That is not only for retirement benefits but for income benefits payable on employees' death or disability.

When we adopted this it was unique in private industry, and it is still an uncommon practice today. The inflation in health cost is even more pronounced than the increase in prices, generally. Furthermore, advances in medical technology have made available lifesaving procedures at a cost far beyond the average pocketbook, and benefit structure of the health insurance industry of 20 years ago. And over that time, we have responded by increasing what was then a lifetime per person limit on health care costs of $20,000 in 1963 to what is now unlimited benefits.

And in response to Senator Durenberger, I think this is illustrative of what happens in the private industry. That, in fact, you don't do everything at once, but that you learn by doing so that you go through this carefully.

Let me get to the last point. Employer sponsored benefits have grown in an unparallel fashion to fill a need for employee economic security. And favorable tax treatment has not been the driving force behind this growth. For the most part, it has been nondiscriminatory and relied on mass insurance principles to prevent an extension of security nets to employees who could never have obtained comparable coverage on their own at an affordable cost.

Although the benefit plans were established largely for relief unrelated to tax policy, this structure could be undermined by major changes in the tax policy. And in my testimony I cite how this can happen. Essentially, when one begins to introduce either reputed income or limitations on these benefits what happens is that the—you have a situation in which the employee—you get more careful cost calculations for the employees. Those employees for whom the mass broad coverage is not favorable will opt out of the plan, and the costs on the average go up. And it's a never ending cycle to the point where the plan is destroyed.

So I would urge that in any change in tax policy that the Congress give very careful consideration to the underpinning of these plans and to what may happen to them by the changes being made.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Garber follows:]

Testimony of Harry D. Garber, Vice Chairman
The Equitable Life Assurance Society of the United States
Subcommittee on Taxation and Debt Management of the Senate Finance Committee
Washington, D.C., July 30, 1984

My name is Harry D. Garber. I am Vice Chairman of The Equitable Life Assurance Society of the United States, the nation's third largest life insurance company. I appreciate the opportunity to appear before this subcommittee today to present our views on the important tax policy issues that you have identified relating to employee benefits.

These questions are significant to us not only as an insurer but also as an employer and sponsor of benefit plans covering some 30,000 employees, agents and retirees.

In my testimony I will seek to discuss some broad concepts that have been applied in the development of the Equitable-sponsored benefit plans, using specific examples drawn from plan actions in recent years. I believe these concepts apply to the plans of many other employers. Let me start with a brief description of the Equitable-sponsored plans and how they have changed over the years.

Equitable established a defined benefit, pay-as-you-go retirement plan for its employees in 1912; in 1943 a funded pension plan was established based on career-average earnings.

In 1938, we introduced a hospital and surgical benefit for our employees; a few years later, a major medical plan was added. The benefits under our plan, then as now, were uniformly available to all employees regardless of earnings or occupational classification. A short term disability plan was added in 1951 and was supplemented in 1964 by a long-term disability plan. Dental benefits were added to our medical plan in 1968. Employer subsidized life insurance has also been a staple in our benefit plans since 1912.

In 1969, we changed our retirement plan from a career accrual to a final pay basis and introduced a profit-sharing investment plan which has encouraged employee accumulations for long-term savings and retirement purposes. Equitable fully matches employee contributions to this plan up to 5% of pay, regardless of salary.

A more detailed description of the plans is presented in Appendix 1; a distribution by salary range of the active employee participants in three of our major plans is shown in Appendix 2.

To give you a sense of the dollars involved, last year Equitable benefit plans paid to active and retired employees and agents or their beneficiaries $34 million in retirement benefits, more than $8 million in disability income, almost $41 million for hospital and medical benefits and $9 million in death benefits. The funds held for future payments under the retirement plan total almost 3/4 of $1 billion.

As an employer, Equitable seeks to maintain an integrated set of plans which will provide, at a minimum, the benefits needed to assure that the various exigencies of life (e.g., illness, disability, death, old age) will not cause a material reduction in the standard of living of the employee and his or her family. This "security net" reduces employees' concern over the possibly catastrophic economic consequences that may otherwise befall them if they incur extensive and extended disability or serious illness or have insufficient retirement income to cope with an uncertain economy. The value of these benefits transcends their economic worth. With the minimization of their concern over protection during an emergency or the adequacy of their funds day to day, our employees are more productive on the job. Good human relations is good business in this respect.

If I may be permitted a personal example. I grew up during the depression. In the middle 1930's my nother had to be hospitalized for a long period. There was no health insurance available and though my father had a good job in those times, the debt was overwhelming and my family struggled for many years to pay it off. Contrast this with the situation sixteen years ago when we found that our two-year old son required open-heart surgery the same week that our oldest daughter began college. Without the health insurance coverages available as an Equitable employee that necessary procedure would have put us in essentially the same position that my parents had been in a generation before. With that coverage, the cost was manageable.

The maintenance of the employee benefit security net requires periodic reviews of and changes in the benefit plan structure. Some examples.

. The experience of the post-war era has made it quite clear that a retirement benefit based on career average earnings will often produce inadequate retirement benefit levels in an inflationary era. In recognition of this problem, we revised the Equitable retirement benefit plan formula several years ago so that retirement benefits are now based on the average salary during the employee's last five years. To assure that income levels remain adequate we have also indexed the benefits to grow with increases in the CPI, but at half of rate increase of the CPI.

. The inflation in health costs has been even more pronounced than the price increases generally. Furthermore, advances in medical technology have made available many new life saving procedures, but at costs far beyond the average pocketbook and the structure of the health insurance benefit of twenty years ago. Equitable responded by increasing the lifetime per-person limit from $20,000 (in 1963) to an unlimited benefit today. Many other employers have followed a similar course.

- One final example. Equitable employees are increasingly using computer terminals with video display units. There is a concern with whether constant use of a video terminal will result in vision impairment. Therefore in the changes in the benefit plans made this year, we have for the first time introduced a limited vision care benefit for our employees. If experience is satisfactory, we would expect to extend this benefit in future years.

In addition to making sure that benefit plans fully reflect the security net needs of its employees, an employer can often serve as a cost-effective, mass-buyer of benefits for employees, particularly with respect to benefits where the employee pays most of the costs involved.

In structuring benefit plans and the cost-sharing arrangements with employees, an employer must be conscious of the size of benefit plan costs in relation to total compensation. Employers are always seeking to keep costs of existing plans to a minimum. In addition to being good business practice, this will assure that funds will be available for any necessary expansion of benefit plans. For example, we have just completed a review of our health insurance plans. Knowing that it was important to add vision care benefit and certain other features, we sought to identify cost-saving actions which would permit us to add to these features with no overall increase in cost. We found that we were able to achieve this by increasing charges to and minimum deductibles for high salaried employees and by introducing certain cost-containment features such as the need for a second opinion on elective surgery.

This brief summary gives you a sense of the philosophy which has guided the development of the benefit plan structure at Equitable. Although other companies undoubtedly approach these questions somewhat differently, I would expect a large degree of overlap in actual practice.

What I believe should be clear from the testimony you will be receiving is that employer sponsored benefits have grown in an unparalleled fashion to fill a need for an employee economic security net and that favorable tax treatment has not been the driving force behind this growth. For the most part this growth has not only been non-discriminatory, and by relying on mass-insurance principles has permitted the extension of the security net to many employees who could never have obtained comparable coverage on their own. In the process benefit plans have become an integral part of the nation's economic security structure.

Although the employer benefit plans component was established largely for reasons unrelated to tax policy, this component could be undermined by major changes in tax policy. This is because of the financial structure design which characterizes many, if not most, employer-sponsored plans. Three key ingredients of such plans are broad coverage (as close as possible to 100%), absence of or limitation on the ability of individual employees to select benefit levels and sufficient employer contribution to assure that the costs paid by the employees with the most favorable risk characteristics will be less than the price at which they could purchase comparable coverage outside of the benefit plan. In fewer words, these plans are universal, relatively simple in design and cost effective. A decision to impose a tax on the "imputed income" received in the form of health insurance or a provision to limit the coverage to tax-free health benefits under a plan to some dollar amount could lead to one of two consecuences. This first would be a complete reassessment of employee contribution formulas to recognize more accurately individual risk levels--a step that would fundamentally change the nature of the plans. The other possible consequence is even worse. It is a scenario in which the best risks opt out of the plan, purchase insurance privately, the experience of the plan becomes worse and the average charge (or "imputed income") goes up; as plan costs per employer increase the best risks among the remaining covered members opt out and the average cost increases again; and this cycle continues until the plan is effectively destroyed. The history of insurance is replete with examples of failures of mass-insurance arrangements based on broad averaging of costs whenever the better risks could purchase insurance privately at a significantly lower cost. And, in this age of tax sophistication, a tax on "imputed income" will be considered by employees to be the same as a direct charge.

Although not a perfect institution, employer-sponsored benefit plans are a significant factor in the economic fabric of the nation. The underlying financial structure of such plans rests on a few fundamental principles of operation and the benign tax structure governing these plans has permitted this institution to develop and flourish with these principles of operations. I would urge the Congress to consider carefully any proposed changes in the tax structure of employer-sponsored benefit plans in order to assure itself that the changes proposed will not impair the essential operations of these plans. The alternative would place a far greater burden on the national treasury than any revenue received from such a step.

APPENDIX I

Additional Features of Equitable Benefit Plans

Retirement Plan

Eligible participants who are age 25 or over are automatically enrolled in our defined benefit retirement Plan. The noncontributory "Final Pay" plan formula provides that employees with 30 years of service are eligible to receive 60% of their five, highest, consecutive years' earnings (out of their final ten years). Benefits are subject to a Social Security offset and actuarial reductions for retirement earlier than age 65.

Capital Accumulation Plan

Employees who are age 21 or over and have at least one year of service are eligible to participate and, in fact, more than 85% of employees have chosen to participate. They can contribute up to 12% of earnings and have several investment options. Through a recent liberalization, all eligible participants are able to receive a 5% employer match on the first 5% of earnings they contribute. Employer contributions are vested in the second, full, calendar year following contribution.

Health Insurance

Equitable has a comprehensive plan covering employees for medical, dental, and psychiatric problems. Both employee premiums and, starting next year, medical deductibles are pay-related. That is, the cost of the participant's premium and the size of the deductible increase with his or her earnings. To reduce the devastating cost impact of catastrophic or prolonged illness or injuries, all participants are limited to spending $1,000 out-of-pocket annually for health insurance claims. All claims over $1,000 are paid at 100% in contrast to the ordinary reimbursement level of 80%. Because health insurance is such a valuable benefit, participation levels at all income brackets are extremely high.

Disability Insurance

Eligibility for Equitable's disability plans starts early. Participants with at least four weeks of service are eligible for the short-term plan. Generally, the amount of the benefit depends on length of service, and, to a lesser extent, on salary. To be eligible for long-term disability, participants must have one year of service. Participants receiving LTD payments for one year or more receive automatic, annual, cost-of-living adjustments.

Life Insurance

Equitable has long provided a minimum level of free life insurance coverage for its employees. This can be supplemented through purchases of additional coverage. All employees are assessed the same charge (which Equitable partially subsidizes). This results in older employees' receiving a substantial benefit for this coverage. No preadmission physical is required.

Additional life insurance benefits are available on an employee-pay-all basis. Interest in this benefit is more a function of age and family status than other factors. Equitable absorbs approximately 90% of the overall cost associated with delivering group life disability and health insurance annually to employees.

Many of the key features in our plans are not dependent upon participants' earnings--they are neutral--and in some cases are tilted toward favoring the longer-service or lower-paid employee. In 1983, the per-participant dollar value of the total package of government-mandated and discretionary benefits averaged $8,578. The employer subsidy thus acts in a particularly beneficial manner for the lower-paid employee.

APPENDIX II

›any Name (Optional) EQUITABLE LIFE

All Employees # 16,900 (incl. ret.)
Salaried Only # 13,400

RETIREMENT PROGRAM AVAILABILITY, 1983

	Defined Benefit				Employer Capital Accumulation				401(k)			
	Participate		Vested		Participate		Vested		Participate		Vested	
	#	%	#	%	#	%	#	%	#	%	#	%
$0-$ 9,999	412	3.3	8	.2	6	–	NOT APPLICABLE		NOT APPLICABLE			
,000- 19,999	6403	51.7	1741	33.0	8978	68.2						
,000- 49,999	4663	37.8	2851	54.0	3422	26.0						
,000- 99,999	753	6.0	567	10.6	646	4.9						
),000 or more	153	1.2	122	2.2	115	.9						
tal	12,384	100%	5289	100%	13,167	100%		100%		100%		100%

Salaried Only #13,400

HEALTH BENEFIT AVAILABILITY, 1983

	Group Insurance		125 Plan		HMO	
	#	%	#	%	#	%
$0-$ 9,999	881	6.5	—	—	3	.5
10,000- 19,999	6776	50.6	—	—	413	70.7
20,000- 49,999	4941	36.8	—	—	154	26.4
50,000- 99,999	640	4.7	—	—	14	2.4
100,000 or more	162	1.4	—	—	0	-
Total	13,400	100%	—	100%	584	100%

Senator PACKWOOD. George, I believe you would like to say something about our next witness.

Senator MITCHELL. Yes, Mr. Chairman. Union Mutual is one of our Nation's oldest, largest insurance companies. It's one of the largest employers in the State of Maine. The good citizens of our State have Mr. Sardegna here on their behalf.

STATEMENT OF CARL SARDEGNA, EXECUTIVE VICE PRESIDENT, UNION MUTUAL LIFE INSURANCE, PORTLAND, ME

Senator PACKWOOD. Mr. Sardegna.

Mr. SARDEGNA. Thank you, Mr. Chairman. Senator Mitchell, I appreciate this honor.

In my current position I am responsible for my company's employee benefits operation. With over $4 billion assets, Union Mutual is one of the Nation's largest life insurers and we are the country's largest provider of group disability coverage. We are a major force in the employee benefits marketplace; particularly, as it relates to small- and medium-sized employers.

I am here today primarily to underscore two fundamental points: First, strong public policy considerations continue to call for Government's support and encouragement of employee benefits. Second, cafeteria or flexible benefit plans represent a sound evolutionary development consistent with these public policy considerations and should be encouraged in order to meet the needs of our Nation's changing demographics and lifestyle patterns.

Since employee benefits essentially protect against casualty events, such as death and illness, they impact individuals indiscriminately across the entire spectrum of our population without regard to age, sex, or economic circumstances. These needs exist and must and will be met. The question from a societal viewpoint is how to meet these needs more effectively and efficiently. They have been met by a combination of Government and private programs. Development and expansion of employee benefit plans have been shown to be an efficient and effective means of assuring that these needs are met. This has been recognized in the past by Congress and encouraged by tax incentives. Indiscriminate and piecemeal approaches to reducing these tax incentives will, to a large extent, only shift the burden to Government, increasing Federal expenditures. In large measure, the result may be that no true revenue will be realized. In fact, it may well be counter productive.

Union Mutual does not support the use of employee benefits as sophisticated tax evasion mechanisms, but neither should we sabotage important public policy objectives by imposing tax restrictions on perfectly legitimate employee benefit programs.

Accordingly, we urge you to recognize in your future deliberations that employee benefits are an impressive American success story. They have evolved in support of Government programs. Congress should take great pain to avoid any disruptions to this delicately balanced system.

With regard to the development of flexible benefit plans, it is important that the nature of these plans be understood by Congress in their deliberations. In the past 30 years, the demographics of our Nation have changed dramatically. The traditional stereotype of a family with two children and one wage earner has declined to less than 15 percent of the total population. Lifestyles and personal attitudes have changed dramatically. Americans are demanding greater individual choice in all aspects of their lives. Flexible benefit plans are a nearly ideal response to the needs of today's Americans.

Very importantly, they increase the effectiveness and efficiency of meeting financial security needs previously described. In effect, they provide a means to essentially take the same amount of dollars and allocate these dollars to meet individual needs without increasing the overall cost of the programs. They help all employees at all levels—the young and the old, the single person and the families, the highly compensated and the not so highly compensated.

Again, it simply bundles existing benefits in a unique and creative manner. It is important to keep the total picture in mind. Total tax of the flexible benefits ought not to be less than nor greater than the tax on each individual piece if not packaged with a flexible benefit plan.

Similarly, the total discrimination standards are not to be either more lax or more onerous in the discrimination rules of each piece.

Thank you very much.

[The prepared written statement of Mr. Sardegna follows:]

STATEMENT OF CARL J. SARDEGNA

EXECUTIVE VICE PRESIDENT

UNION MUTUAL LIFE INSURANCE COMPANY

BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT FRINGE BENEFIT HEARINGS

JULY 1984

GOOD MORNING, MY NAME IS CARL J. SARDEGNA, EXECUTIVE VICE PRESIDENT OF UNION MUTUAL LIFE INSURANCE COMPANY OF PORTLAND, MAINE. WITH OVER $4 BILLION OF ASSETS UNION MUTUAL IS THE NATION'S 34TH LARGEST LIFE INSURANCE COMPANY. THE INDUSTRY LEADER IN GROUP DISABILITY INSURANCE FOR SEVEN CONSECUTIVE YEARS, UNION MUTUAL IS A MAJOR FORCE IN THE NATIONAL EMPLOYEE BENEFITS MARKETPLACE. OUR PORTFOLIO ALSO INCLUDES LIFE, MEDICAL AND DENTAL COVERAGES, AS WELL AS A WIDE ARRAY OF GROUP PENSION PRODUCTS.

I AM A MEMBER OF THE GROUP INSURANCE COMMITTEE OF THE AMERICAN COUNCIL OF LIFE INSURANCE, AND MY COMPANY IS VERY ACTIVE IN THE ACTIVITIES OF BOTH THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE HEALTH INSURANCE ASSOCIATION OF AMERICA. WHILE I DO NOT INTEND TO REPEAT THE TESTIMONY PROVIDED TODAY BY THOSE TWO ASSOCIATIONS, I WANT TO ADD MY COMPANY'S STRONG SUPPORT TO THOSE REMARKS, AND URGE UPON YOU THEIR SERIOUS CONSIDERATION.

I AM HERE TODAY PRIMARILY TO UNDERSCORE TWO FUNDAMENTAL POINTS. FIRST, STRONG PUBLIC POLICY CONSIDERATIONS CONTINUE TO CALL FOR GOVERNMENTAL SUPPORT AND ENCOURAGEMENT OF EMPLOYEE BENEFITS. SECOND, CAFETERIA, OR FLEXIBLE BENEFIT PLANS, REPRESENT A SOUND EVOLUTIONARY DEVELOPMENT CONSISTENT WITH THESE PUBLIC POLICY CONSIDERATIONS, AND SHOULD BE ENCOURAGED IN ORDER TO MEET THE NEEDS OF OUR NATION'S NEW DEMOGRAPHIC AND LIFESTYLE PATTERNS IN THE FUTURE.

EMPLOYEE BENEFITS ARE DESIGNED TO MEET THE SECURITY NEEDS OF INDIVIDUALS AND FAMILIES AND TO PROTECT THEM FROM THE ADVERSE FINANCIAL CONSEQUENCES OF SICKNESS, DEATH, DISABILITY, RETIREMENT AND SIMILAR EVENTS.

SINCE THESE ARE ESSENTIALLY CASUALTY EVENTS, THEY IMPACT INDIVIDUALS INDISCRIMINATELY ACROSS THE ENTIRE SPECTRUM OF OUR POPULATION WITHOUT REGARD TO AGE, SEX OR ECONOMIC CIRCUMSTANCES. THESE NEEDS EXIST AND MUST AND WILL BE MET.

THE QUESTION FROM A SOCIETAL VIEWPOINT IS HOW TO MEET THESE NEEDS MOST EFFECTIVELY AND EFFICIENTLY.

THE DEVELOPMENT AND EXPANSION OF EMPLOYEE BENEFIT PLANS IN THIS COUNTRY HAS BEEN SHOWN TO BE AN EFFICIENT AND EFFECTIVE MEANS OF ASSURING THAT THESE NEEDS ARE MET FOR A BROAD SPECTRUM OF OUR POPULATION THROUGH PRIVATE SECTOR ACTION AND PRIVATE SECTOR DECISIONS. THIS HAS BEEN RECOGNIZED IN THE PAST BY CONGRESS AND ENCOURAGED BY TAX INCENTIVES. INDISCRIMINATE AND PIECEMEAL APPROACHES TO RAISING THESE TAX INCENTIVES WILL, TO A LARGE EXTENT, ONLY SHIFT THE BURDEN TO A GOVERNMENT EXPENSE. THE RESULT IS THAT NO TRUE REVENUE WILL BE REALIZED. IN FACT, IT MAY BE COUNTER PRODUCTIVE.

IT SHOULD BE POINTED OUT EMPHATICALLY THAT UNION MUTUAL DOES NOT SUPPORT THE USE OF EMPLOYEE BENEFITS IN ORDER TO SECURE IMPROPER WINDFALLS TO CERTAIN CLASSES OF EMPLOYEES; NOR ARE WE UNMINDFUL OF THE EXISTENCE OF ABUSIVE PRACTICES (SUCH AS

ZEBRAS). WE SHOULD NOT PERMIT THE USE OF EMPLOYEE BENEFITS AS SOPHISTICATED TAX INVASION MECHANISMS BUT NEITHER SHOULD WE SABOTAGE IMPORTANT PUBLIC POLICY OBJECTIVES BY IMPOSING TAX RESTRICTIONS ON PERFECTLY LEGITIMATE EMPLOYEE BENEFIT PROGRAMS.

ACCORDINGLY, WE URGE YOU TO RECOGNIZE IN YOUR FUTURE DELIBERATIONS THAT FRINGE BENEFITS ARE AN IMPRESSIVE AMERICAN SUCCESS STORY. THE QUALITY OF TENS OF MILLIONS OF LIVES HAVE BEEN DRAMATICALLY IMPROVED BY PRIVATELY PROVIDED AND PRIVATELY FINANCED EMPLOYEE BENEFITS PROGRAMS WHICH HAVE EVOLVED IN THE PAST 30 YEARS TO SUPPORT GOVERNMENT PROGRAMS. CONGRESS SHOULD TAKE GREAT PAINS TO AVOID ANY DISRUPTION TO THIS DELICATELY BALANCED SYSTEM.

WITH REGARD TO THE DEVELOPMENT OF FLEXIBLE BENEFIT PLANS (SOMETIMES KNOWN AS CAFETERIA PLANS), IT IS IMPORTANT THAT THE NATURE OF THESE PLANS BE FULLY UNDERSTOOD BY CONGRESS IN THEIR DELIBERATIONS.

IN THE PAST 30 YEARS THE DEMOGRAPHICS OF OUR NATION HAS CHANGED DRAMATICALLY. THE TRADITIONAL STEREOTYPE OF A FAMILY WITH TWO CHILDREN AND ONE WAGE EARNER HAS DECLINED TO LESS THAN 15% OF THE TOTAL POPULATION. AS MORE AND MORE WOMEN HAVE ENTERED THE WORK FORCE, TWO EARNER FAMILIES HAVE BECOME THE NORM RATHER THAN THE EXCEPTION. SINGLE HOUSEHOLDS AND SINGLE PARENT FAMILIES HAVE PROLIFERATED. LIFESTYLES AND PERSONAL ATTITUDES HAVE CHANGED DRAMATICALLY. PARTIALLY IN RESPONSE TO THE DEPERSONALIZATION OF THE AUTOMATED AGE AND PARTIALLY FACILITATED BY THE CAPABILITIES OF THE AUTOMATED AGE, AMERICANS ARE DEMANDING GREATER INDIVIDUAL CHOICE IN ALL ASPECTS OF THEIR LIVES.

FLEXIBLE BENEFITS PLANS ARE A NEARLY IDEAL RESPONSE TO THE NEEDS OF TODAY'S AMERICANS. THEY ADVANCE OUR PREFERENCE FOR INDIVIDUAL DECISION-MAKING TO A NEW LEVEL OF REFINEMENT BY FACILITATING INDIVIDUAL RATHER THAN GROUP SELECTION OF DESIRED BENEFITS. PRIVATE SECTOR RESPONSIBILITY, WITH A MINIMUM OF

GOVERNMENTAL CONCERN, IS PRESERVED AND EXTENDED. MOST IMPORTANTLY FLEXIBLE BENEFITS INCREASE THE VALUE TO THE CONSUMER BY ALLOWING HIM OR HER TO TAILOR THESE BENEFITS TO INDIVIDUAL NEEDS RATHER THAN THE NEEDS OF AN AVERAGE POPULATION.

VERY IMPORTANTLY, FLEXIBLE BENEFITS SIGNIFICANTLY INCREASES THE EFFICIENCY AND EFFECTIVENESS OF MEETING THE FINANCIAL SECURITY NEEDS DISCUSSED PREVIOUSLY. IN EFFECT, IT PROVIDES A MEANS TO TAKE ESSENTIALLY THE SAME AMOUNT OF DOLLARS AND ALLOCATE THESE DOLLARS TO MEET DIFFERENT NEEDS WITHOUT INCREASING THE OVERALL COSTS OF THE PROGRAMS. IT IS, IN OUR VIEW, A MAJOR SIGNIFICANT BREAKTHROUGH.

YET, FLEXIBLE BENEFITS ARE NOT REALLY <u>NEW</u> BENEFITS AT ALL. RATHER, FLEXIBLE BENEFIT PLANS ARE PURELY A REPACKAGING OF EXISTING BENEFITS IN A MANNER WHICH UNIFIES THEM INTO A VEHICLE FOR INDIVIDUAL CHOICE TO MEET INDIVIDUAL NEEDS. THEY BENEFIT

ALL EMPLOYEES AT ALL LEVELS -- THE YOUNG AND THE OLD, THE SINGLE PERSON AND THE FAMILY, THE HIGHLY COMPENSATED AND THE NOT SO HIGHLY COMPENSATED. A FLEXIBLE BENEFIT PACKAGE GENERALLY DOES NOT CONVERT AN OTHERWISE TAXABLE BENEFIT INTO A NONTAXABLE ONE. AGAIN, IT SIMPLY BUNDLES EXISTING BENEFITS IN A UNIQUE AND CREATIVE WAY-- A WAY WHICH DRAMATICALLY ENHANCES THE PARTICIPANT'S ABILITY TO MEET HIS OR HER NEEDS. THUS, FLEXIBLE BENEFIT PLANS ARE IN TOTAL HARMONY WITH ENLIGHTENED NATIONAL POLICY.

IN ITS DELIBERATIONS ON EMPLOYEE FRINGE BENEFITS, CONGRESS SHOULD REVIEW THE EXISTING TAX LAWS TO ASSURE THAT THEY RECOGNIZE FLEXIBLE BENEFIT PLANS AND TREAT THEM AS A WHOLE, RATHER THAN A PIECEMEAL COLLECTION OF BENEFITS. WHEN COMBINED UNDER THE UMBRELLA OF FLEXIBLE BENEFIT PLANS, EMPLOYEE BENEFITS TAKE ON A VALUE TO THE WORK FORCE WHICH EXCEEDS THE SUM OF THEIR INDIVIDUAL PARTS.

THE TAX LAWS SHOULD ADDRESS THIS UMBRELLA OF FLEXIBLE BENEFITS AND REGULATE IT AS SUCH. IT IS IMPORTANT TO KEEP THE TOTAL PICTURE IN MIND. THE TOTAL TAX OF THE FLEXIBLE BENEFITS PACKAGE OUGHT NOT TO BE LESS THAN OR GREATER THAN THE TAX ON EACH INDIVIDUAL PIECE IF PACKAGED WITHIN A FLEXIBLE BENEFITS PLAN. SIMILARLY, THE TOTAL DISCRIMINATION STANDARD OUGHT NOT TO BE EITHER LAX OR MORE ONEROUS THAN THE DISCRIMINATION RULES OF EACH PIECE. IN SUM, SECTION 125 OF THE INTERNAL REVENUE CODE AS CURRENTLY WRITTEN FAILS ADEQUATELY TO RECOGNIZE THE TRUE NATURE OF FLEXIBLE BENEFIT PLANS AND HAS LED THE IRS TO ADOPT UNWARRANTED BIAS TOWARDS RESTRICTING THESE PLANS AND REGULATING THEM IN PIECEMEAL FASHION.

FLEXIBLE BENEFIT PLANS PROVIDE A UNIQUE OPPORTUNITY TO PROVIDE GREATER VALUE, FACILITATE PUBLIC POLICY AND POTENTIALLY HOLD OUT THE HOPE OF CONTAINING THE RISING COSTS OF MEETING THESE NEEDS. IT IS CRITICAL THAT CONGRESS RECOGNIZE THE NATURE OF THESE PLANS AND THEIR POTENTIAL DURING THEIR DELIBERATIONS.

OBVIOUSLY, THE SUBJECT OF EMPLOYEE FRINGE BENEFITS IS ONE OF ENORMOUS COMPLEXITY AND IMPORTANCE BOTH TO THE REVENUES OF THE FEDERAL GOVERNMENT AND TO THE WELL BEING OF THE AMERICAN PEOPLE. THESE BRIEF REMARKS MERELY SERVE TO HIGHLIGHT TWO KEY CONCERNS WHICH UNION MUTUAL WISHES TO PLACE BEFORE YOU AS YOU BEGIN YOUR EXTENDED DELIBERATIONS. WE APPLAUD YOUR EFFORTS IN THIS REGARD, AND STAND READY TO PROVIDE YOU AND YOUR STAFF WITH WHATEVER ASSISTANCE MAY BE HELPFUL TO YOU AS YOU CONTINUE YOUR EFFORT.

THANK YOU VERY MUCH FOR THE PRIVILEGE OF APPEARING BEFORE YOU TODAY.

Senator PACKWOOD. All of your statements are accurate. You make one statement that is particularly true. You talked about the Treasury and the revenue that it thinks it is going to get—"indiscriminate and piecemeal approaches to raise these tax incentives will, to a large extent, only shift the burden to a Government expense. The result is no true revenue will be realized."

The Treasury Department, in estimating revenues, operates on what it calls a static basis. It assumes no change in behavior based upon a change in tax laws. We double the income tax, we will double the income tax collections. If we quadruple it, we will quadruple the income tax collections. Raise it 100 times, we will get 100 times more. Well, people do respond. At some stage you are not going to get exactly, the increase or decrease in revenue based upon the percentage of increase or decrease in the tax.

I don't blame Treasury too much because if they don't use a static estimate, then they have to put in whatever subjective formula they can come up with to try to estimate what people will do in response to a change in the Tax Code.

So long as you understand that Treasury uses static revenues, you can understand how they come out. You have to simply understand that in using that basis, the one thing you can be absolutely sure of, if they are going to use a static base of projection, is that the revenues that the Treasury Department predicts will not be the revenues that will result. That you can bank on 100 percent. Dave.

Senator DURENBERGER. Mr. Garber, does Equitable have health insurance?

Mr. GARBER. Do we have health insurance?

Senator DURENBERGER. Yes.

Mr. GARBER. Yes.

Senator DURENBERGER. I mean do you have an operating company?

Mr. GARBER. Yes; Equitable itself sells both health insurance to employers and it administers employer health plans, and also sells individual health plans.

Senator DURENBERGER. What percent of the market do you have?

Mr. GARBER. Oh, I would think on the lawyer's side since Blue Cross-Blue Shield has 50 percent, I think we probably have about 10 percent of the insurance company market or a little less. I think somewhere around 4 or 5 percent.

Senator DURENBERGER. As you described your health coverage available to your employees, is that like a self-insured plan or your own plan?

Mr. GARBER. Well, we deal with ourselves as an insurance company so that we, Equitable, the employer, has Equitable, the insurance company, to provide this kind of benefit.

Senator DURENBERGER. And do you provide your employees with other choices of health plans?

Mr. GARBER. Other what?

Senator DURENBERGER. Other choices of health plans.

Mr. GARBER. Only the HMO choice, which is mandated by law. We have not gotten into a cafeteria-type benefit at this point.

Senator DURENBERGER. And is that for all the reasons that you outlined on page 7, which are your objections to any of a limit on the tax-free nature of the plans which deal with behavior of people in response to this system?

Mr. GARBER. I think I would say that it's not that we wouldn't want to do that some time down the road. We have been waiting somewhat for a tax policy to clarify in this area.

But also in a very large company, cafeteria plans get to be very complicated to deal with. I think one wants to assure that there is some minimum base kind of protection and wouldn't want people to opt out of any protection just because they would like to have their money put somewhere else. And, furthermore, the design of such a plan requires considerable attention to making sure that the costs don't increase because people do choose the thing which they are most interested in and which may be most beneficial to them.

All of these health matters, really, has been that you move cautiously in a limited fashion. I think the introduction of vision care is typical. We introduced limited benefit. We see how it goes; what it costs. Then we gradually expand it and modify it over time, when we get a better fix on what the cost structure is and what sort of limitations have to be built in to prevent it from being abused.

Senator DURENBERGER. Thank you.

Senator PACKWOOD. George.

Senator MITCHELL. Mr. Sardegna, the dental program. Has that been a popular program? Do you think it would be jeopardized by a tax cap?

Mr. SARDEGNA. It has been a popular program. It's difficult to tell which, benefits will be jeopardized by a tax cap. But it is clear that if you propose a tax cap, it becomes less beneficial to employees and employers to provide more comprehensive benefits, and somewhere, the total pie will shrink. Exactly where it will shrink is difficult to tell.

Senator MITCHELL. Do you know where deductible—are there any other similar measures with which you are familiar?

Mr. SARDEGNA. I referred to one that I think in the long term can be a very important measure in containing costs, and that's flexible benefits. If, in fact, you give people individual choices and you get them involved in the decisionmaking process you can help reduce or contain the escalating cost of medical care and other types of coverages. Right now, there is no incentive for them to become involved in the process. Flexible benefits provide a means for them to become involved in the process.

Similarly, we have been encouraging—and there is a growing evidence of this throughout the United States—wellness-type programs which extend beyond purely insured benefits to really focus attention on keeping people well. And, in fact, if there is encouragement by Congress wellness programs and flexible benefits are, major ways for us to reduce the total cost.

Senator MITCHELL. Thank you.

Senator PACKWOOD. Thank you, gentlemen.

Senator PACKWOOD. Next we will take Sally Goldfarb, representing the National Women's Law Center; Willis Goldbeck, president of the Washington Business Group on Health; Donald Bentley, the president of the American Dental Association; Cheryl Westphal, the President of the American Dental Hygienists; and Roger Bruggmier, chairman of the Retirement and Insurance Committee of the Air Line Pilots Association.

We will start with Ms. Goldfarb.

STATEMENT OF SALLY F. GOLDFARB, NATIONAL WOMEN'S LAW CENTER, WASHINGTON, DC

Ms. GOLDFARB. Mr. Chairman, and members of the committee, thank you for the opportunity to appear here this morning. I am Sally Goldfarb, and with me is Nancy Duff Campbell. We are both attorneys with the National Women's Law Center, which is a legal organization working to preserve and advance women's rights.

Our testimony today is also presented on behalf of three other organizations—the National Women's Political Caucus, the Project on Equal Education Rights of the NOW Legal Defense and Education Fund, and Wider Opportunities for Women.

We have prepared written testimony which has been submitted for the record. I will cover a few major points today.

The subject of our testimony is employer cafeteria plans and their potential to help meet the growing need for dependent care assistance among American workers. This need is especially great among women workers, who are more likely than men to have responsibility for providing care not only for children but also for disabled or elderly relatives.

We very much appreciate the Congress' attention to cafeteria plans. In particular, we welcomed the inclusion of transition rules for existing cafeteria plans in the recent Deficit Reduction Act. However, many of the legal requirements for cafeteria plans remain very unclear. The proposed IRS regulations of May 7 did not address many of these issues or addressed them in ways that we feel were inappropriate. So we hope that the subcommittee will monitor the development of final regulations, and when necessary, initiate legislation to resolve remaining problems.

Employers are beginning to show increased interest in helping workers meet their dependent care needs, but many employers will be unwilling to set up cafeteria plans if they cannot be sure of the legal requirements that they have to meet.

Today we would like to discuss the requirements for nondiscrimination in cafeteria plans. The Deficit Reduction Act set up a two-part discrimination standard for cafeteria plans, geared to both highly compensated employees and key employees. These two discrimination standards should be more clearly defined, and they should be coordinated both with each other and with the separate discrimination standards that apply to specific components of cafeteria plans such as dependent care assistance programs. The discrimination rule should be more responsive to differences among employers. A rule that no more than 25 percent of nontaxable benefits may be provided to key employees has very different effects on small and large employers. Among small employers, the number of participants may be so low that the tax status of a plan may suddenly shift because one low-paid employee has reduced her benefit elections. This type of unpredictability makes cafeteria plans unworkable for most small employers.

The discrimination standards also should be responsive to differences among the employees of a given employer. There may be legitimate disparities in election of nontaxable benefits, between those who have children or other dependents and those who do not. Also, lower paid workers who do have dependents may not use cafeteria plans for dependent care because they rely on title XX care or on the dependent care tax credit, which is more advantageous than salary reduction for most families with adjusted gross incomes below about $26,000.

An issue related to discrimination, which is receiving increasing attention, is the idea of a ceiling or cap on tax free benefits available under cafeteria plans. If such a cap is imposed, it needs to have the following characteristics. First, dependent care should be capped separately from other cafeteria plan benefits. Second, the use of a cafeteria plan up to its cap for dependent care should not reduce the availability of the dependent care tax credit for other additional care expenses. This is not double dipping because either the dependent care tax credit or salary reduction, but not both, would be available for a given dollar in care expenses. Third, any cafeteria plan cap should apply only to salary reduction since employers should be encouraged to provide their own funds for these benefits whenever possible.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Ms. Goldfarb follows:]

TESTIMONY OF

NATIONAL WOMEN'S LAW CENTER;

NATIONAL WOMEN'S POLITICAL CAUCUS;

THE PROJECT ON EQUAL EDUCATION RIGHTS
OF THE N.O.W. LEGAL DEFENSE FUND;

and

WIDER OPPORTUNITIES FOR WOMEN

BEFORE THE

UNITED STATES SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

CONCERNING

FRINGE BENEFITS

JULY 30, 1984

Prepared by:

Sally F. Goldfarb
Nancy Duff Campbell
National Women's Law Center
1751 N Street, N.W.
Washington, D.C. 20036
(202) 872-0670

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Mr. Chairman and members of the Committee, the National Women's Law Center is a national legal organization which has worked for over a decade to preserve and advance women's legal rights. We are pleased to have this opportunity to testify on employer cafeteria plans. Our testimony today is also presented on behalf of the National Women's Political Caucus, the Project on Equal Education Rights of the N.O.W. Legal Defense and Education Fund, and Wider Opportunities for Women.

Cafeteria plans can provide important tax savings for women workers. In particular, cafeteria plans, when they incorporate dependent care assistance programs, have the potential to offer significant support to workers who have dependent care expenses, the majority of whom are women.

The need for assistance with the costs of dependent care is widespread, and the need is growing as more and more women enter the paid labor force. Today, the paid labor force includes 31 percent of married women with children under the age of one year, almost 46 percent of all women with children under the age of three, and almost 57 percent of all women with children aged three to five. These numbers are expected to increase during this decade.

The need for dependent care assistance is not limited to families with young children. Frequently, elderly family members need care. One in ten of all women aged 45 to 65 have responsibility for an older relative, and one out of eight retired women reported in 1975 that they had retired because they were needed at home to care for dependents. Disabled family members also require care. There are approximately 500,000 disabled children under the age of six and 4.2 million disabled school-aged children in this country, as well as 8.4 million severely disabled adults between the ages of 18 and 64 who are living in families with at least one other adult.

Women who work outside the home to provide financial support for themselves and their families often have great difficulty meeting the costs of care for their dependents. As the following table shows, average costs for dependent care are high.

Average Dependent Care Costs

Infant (under 2 years)

-- group or center: $3,000 - $5,000 per year

-- family day care: $1,800 - $3,500 per year

Child (3-5 years)

-- group or center: $2,200 - $3,200 per year

-- family day care: $1,200 - $2,200 per year

Child (school age)

-- $10 - $50 per week

Adult

-- $11.82 - $50 per day

As women struggle to meet the care needs of their dependents while maintaining paid employment, every source of assistance, including cafeteria plans, can be enormously important. Of course, cafeteria plans will never be a dependent care panacea. For instance, increased direct funding through Title XX of the Social Security Act is indispensable for the most needy families. Also, we are very concerned that the use of cafeteria plans could significantly erode workers' Social Security benefits, because portions of salary converted to nontaxable benefits are not subject to Social Security tax; we are studying this issue to assess its impact on women workers and hope that the Subcommittee will consider and attempt to resolve this problem. Nevertheless, cafeteria plans have the potential to make a contribution toward meeting the pressing dependent care needs of American workers. Our testimony today is directed toward identifying ways in which the legal contours of cafeteria plans could be shaped to realize that potential.

First, we commend the Congress's recent attention to the requirements for cafeteria plans. In particular, we welcomed the passage of legislation establishing transition rules for existing plans. However, many issues affecting cafeteria plans remain to be clarified. Since the proposed I.R.S. regulations did not address many of these issues, or addressed them in ways we feel were inappropriate, we hope that the Subcommittee will monitor the I.R.S.'s development of final regulations and when necessary devise legislation to resolve remaining problems. Today, we will discuss the issues of carryover and cash-out of unused benefits, the length of the plan year, changes in family status, the discrimination standards, and the question of a ceiling, or cap, on tax-free dependent care benefits.

Subject to the effective dates in the transition rules, the proposed regulations would require that all benefits which an employee elects but does not actually receive during a plan year would be forfeited. Any carryover to a future plan year, or reimbursement of the cash value of the unused benefits, would be prohibited. We feel that this treatment is unduly harsh and would undermine important public policy goals. The severity of the "use it or lose it" rule will lead employees not to participate, or to underestimate their elections of nontaxable benefits under salary reduction agreements, in order to avoid possible forfeiture. Lower-paid workers will be less able to risk losing any compensation and will thus be more likely not to participate, or to underestimate nontaxable expenses significantly, choosing taxable cash instead. The result will be that workers, especially those with lower pay, will be unable fully to reap the intended advantages of using a cafeteria plan to pay qualifying expenses out of pre-tax dollars. For those workers whose projections of dependent care expenses or other covered costs are indeed too high, automatic forfeiture is too severe a penalty. At a minimum, carryover of unused benefits to a future plan year should be permitted. In addition, cash-out of unused benefit amounts would be taxable and thus would actually result in increased tax revenue.

Especially in light of any restrictions on carryover and cash-out of unused benefits, plan years of less than twelve months' duration should be explicitly permitted. (The proposed I.R.S. regulations do not specify the minimum permitted length for plan years, but state that plans of twelve months' duration will be acceptable.) Covered expenses, including dependent care, are often difficult to predict as far in advance as twelve months. A twelve-month plan year thus discourages employee participation. Permitting shorter plan years can allow employees to make realistic projections of their benefit needs without sacrificing the requirement that employees elect their benefits before expenses are incurred.

Once the plan year has begun, the proposed I.R.S. regulations would not permit employees to begin or end participation, revoke a benefit election, or make a new election, except if there has been a change in family status. The change in status exception is crucial for preserving necessary flexibility within cafeteria plans. The changes in status listed in the proposed I.R.S. regulations -- marriage, divorce, death of spouse or child, birth or adoption of child, and termination of employment of spouse -- are only a few examples of many. While legislation explicitly recognizing other changes in status may not be appropriate, legislative history could be useful in providing the I.R.S. with guidance on other examples. For instance, a change to part-time from full-time work or any other change in work hours or employee status, by either an employee or the employee's spouse, could greatly alter employees' cafeteria plan needs by changing their eligibility for non-cafeteria-plan employee benefits or by changing their need for paid dependent care. The beginning or end of a family member's illness, disability, or other condition causing inability to care for oneself, is another significant change in status. If an employee's father becomes unable to care for himself, and the employee must pay a care provider to come into her home to care for her father while she works, she should not have to wait until a new plan year begins in order to elect to participate in the dependent care assistance program available under her cafeteria plan. Similarly, if her father recovers, she should not be locked into a fixed amount of dependent care benefits. Other examples of significant changes in status are a change in schooling for a dependent, a move, and the hiring or loss of a care provider. In addition, an employee who revokes her election during the plan year, and has benefits remaining which she has not yet used, should be explicitly permitted to use up those benefits.

Reevaluation and clarification of the discrimination standard for cafeteria plans is urgently needed. The proposed regulations, read in conjunction with the recently-passed tax legislation, appear to provide the following two-part standard. A discriminatory plan is one which discriminates in favor of highly compensated individuals as to eligibility to participate, or in favor of highly compensated participants as to contributions and benefits, see 26 U.S.C. §125(b)(1) as amended (with "highly compensated" defined as someone who is an officer, a shareholder owning more than five percent of the voting power or value of all classes of stock of the employer, or highly compensated, see Answer #13 of proposed regulations); or one which provides to key employees over 25 percent of the aggregate statutory nontaxable benefits provided for all employees under the plan, see 26 U.S.C. §125(b)(2) as amended (with "key employees" defined as officers of the employer earning more than $45,000 a year, see 26 U.S.C. §416(i)(1)(A)(i) as amended, or one of the ten employees owning or considered as owning the largest interests in the employer, _see_ 26 U.S.C. §416(i)(1)(A)(ii), or a five-percent owner of the employer, _see_ 26 U.S.C. §416(i)(1)(A)(iii), or a one-percent owner of the employer having an annual compensation from the employer of more than $150,000, _see_ 26 U.S.C. §416(i)(1)(A)(iv)).

This two-part standard leaves open many questions not answered by the proposed regulations or existing legislation. Some legislative action should be forthcoming to ensure that these questions are addressed. Most importantly, the dual discrimination standard should be streamlined and simplified -- and integrated with the separate discrimination standards applicable to specific components of cafeteria plans, such as that for dependent care assistance programs, 26 U.S.C. §129(d)(2), (4) -- in order to eliminate redundancy and confusion. Currently, the relationship between the "highly compensated" category and the "key employees" category is not clear, and the two categories -- and the tests for each -- appear to overlap. Remaining questions also include the definition of "highly compensated"; the test for determining whether a plan discriminates in favor of the highly compensated as to eligibility to participate or as to contributions and benefits; and the meaning of the phrase "benefits provided" in determining whether the key employees test is met (does it mean nontaxable benefits which are available to key employees, or elected by key employees, or received by key employees?).

In refining the discrimination rules, two crucial principles should be observed.

First, the discrimination rules must be responsive to differences among employers. A rule that no more than 25 percent of nontaxable benefits may be provided to key employees has a predictable impact on a conventional employer with a preponderance of staff members at low salaries, but it has an entirely different impact on employers such as small, non-profit organizations (as well as certain high-technology and entrepreneurial enterprises), where "key employees" often constitute the overwhelming majority of the work force. Among the latter employers, the key employees rule often operates in a highly erratic and unpredictable manner. For instance, among small employers, tax-free benefits already received by a higher-paid employee may suddenly become taxable because one low-paid employee has reduced her election due to a change in family status. Such uncertainty renders cafeteria plans unworkable for many small employers.

Second, the discrimination standard must be responsive to differences among the employees of a given employer. Differences in the need for and use of benefits by different people in the same work force may lead to results that appear discriminatory but in fact are based on non-discriminatory factors. This is a particularly pressing problem in the dependent care area, because dependent care expenses may account for huge disparities in election of nontaxable benefits between those who have children or other dependents in need of care and those who do not.

Indeed, as the age of child-bearing goes up, younger, lower-paid workers may be less likely to have children than somewhat older, more highly-paid workers. Also, older workers more commonly have an elderly parent in need of paid care. Moreover, those lower-paid workers who do have dependents are frequently unlikely to use salary reduction as a way of financing their dependent care expenses, because more advantageous alternatives exist for them. Low-income workers may be eligible for free or subsidized dependent care under Title XX programs. Also, the dependent care tax credit is initially more advantageous than salary reduction for most families with adjusted gross incomes below about $26,000. Therefore, the fact that lower-paid workers do not elect salary reduction for dependent care as readily as their more highly-paid coworkers should not necessarily be attributed to discrimination on the part of the employer's cafeteria plan.

An issue which has received increasing attention is the idea of imposing a ceiling, or cap, on tax-free benefits available under cafeteria plans. If such a cap is imposed, we urge that it have the following characteristics.

First, dependent care should be capped separately from other cafeteria plan benefits, in recognition of the major difference in benefit needs between employees who do and do not have dependent care expenses.

Second, the use of a cafeteria plan up to its cap for dependent care should not reduce the availability of the dependent care tax credit for other, additional care expenses. This is necessary because many forms of care -- including infant care and care for the frail elderly -- are routinely so expensive that the support of both salary reduction and the dependent care credit will frequently be needed. This is not "double-dipping," because for a given dollar of dependent care expenses, either the credit or salary reduction could be used, but not both. No integration exists between the itemized medical deduction and cafeteria plan medical benefits; similarly, the tax system should not curtail its available dependent care benefits by imposing an integrated cap on the dependent care tax credit and dependent care assistance under cafeteria plans. However, if a unified, integrated cap of $2,400 for one dependent, or $4,800 for two or more dependents, were established for both salary reduction and the credit, then that ceiling and the dependent care tax credit's own statutory maximum should both be indexed, so that they both rise together with inflation.

Finally, any cafeteria plan cap should apply only to salary reduction. Employers willing to provide their own funds for benefits should be encouraged to do so to the full extent of their resources, as long as the results are nondiscriminatory. Indeed, greater employer support for dependent care is urgently needed.

In conclusion, Congressional action is necessary to assure that the above issues either are addressed directly through legislation or are resolved through prompt regulatory activity by the I.R.S. Six years after passage of Section 125, and three years after passage of Section 129, the remaining legal ambiguities pose a hardship for employers who wish to establish legitimate plans but hesitate to proceed without clear guidelines; for their employees who may be denied the many benefits of cafeteria plans while the employers are forced to wait for further guidance; and for both employers and employees who are faced with possible penalties if they go forward with cafeteria plans which may eventually be found invalid. The I.R.S. press release and proposed regulations issued this year have had a chilling effect on many employers. Particularly in light of the pressing dependent care needs of many workers, speedy action toward clear and comprehensive legal standards for cafeteria plans is called for.

STATEMENT OF WILLIS B. GOLDBECK, PRESIDENT, WASHINGTON BUSINESS GROUP ON HEALTH, WASHINGTON, DC

Senator PACKWOOD. Mr. Goldbeck.

Mr. GOLDBECK. Good morning. I am Willis Goldbeck, the president of the Washington Business Group on Health.

I think from the health perspective we have really a singular objective—to create an efficient medical marketplace. To do so requires a cooperative venture of Government and the private sector developing an integrated strategy for cost management, liking the efforts involving control of utilization, reimbursement and systems capacity.

One facet of all of this is recognizing that, in fact, we are talking about the end of traditional insurance. The insurance market, if you will, is going to be prepaid, negotiated, involving choices which are designed to create adverse selections based on precertification. That is not the model that you all began to regulate or that the rest of us began to know many years ago.

On your immediate agenda, the Educational Assistance Act needs, with your leadership again, to come back to life. It is utterly preposterous to consider that we want to make our population more educated to deal with the change in nature of work in America, more educated to deal with sophisticated employee benefit issues, but we don't want to provide any assistance to accomplish these rational goods.

Obviously, by now you have heard enough about section 125 plans. Let me only echo the point that it seems rather ridiculous to study the plans if we are not going to allow them exist enough to study them. It is inherently contradictory. You have enough activity going on out there among creative folks, some of which are going to succeed and make a contribution if they are allowed to go forward. If they are not allowed to go forward, you end up with only one totally predictable result—a lost opportunity.

I think it's important that the Congress understand that it is giving very conflicting messages. On the one hand we want to have employees participate more in costs, and we want to avoid tax losses so we eliminate the opportunity for employers to take as a deduction the amount that they contribute to employees for things like smoking cessation programs. On the other hand, we cave into a few select Members of the Congress and reduce the cigarette taxes by half, an embarrassment for anybody seriously interested in human health.

Senator PACKWOOD. Let me just suggest this. [Laughter.]

You are a betting man. I would not place any money on the side of that tax going down permanently. I would be inclined to bet that that tax never goes down at all. You recall it doesn't run out until the end of next year.

Mr. GOLDBECK. I am delighted with your response, and to whatever extent we can encourage and support it, we will be delighted to do so.

One of the important aspects of fringe benefits is giving the employees and their families assistance in the management of fringe benefits. You have an opportunity to do so in H.R. 5602, with the Wyden amendment, now title 5, which supports the concept of disclosure of comparative price, utilization and quality statistics. This is central to the concept of choice, to the concept of competition, to the concept of a free market. The only people who have a reason to oppose it are those who have something to hide or don't respect the intelligence of the public.

The point is that government needs to be a risk taker, to be an innovator, to be a leader in this area. I have tried to point out in my testimony, the written part, that the real issues in terms of fringe benefits are not the tinkering with today's designs, but the recognition that this Nation cannot and I would suggest will not pay for 20 to 40 year retirement periods. That's the issue that cries out for major leadership. Leadership to help decide what the next major trends are. When is that next baby boom going to come or is it never? What are the implications of that, of the old, old, or of the female working population.

When you look at the intervention of government in fringe benefits—many times very valuable and very important—there are certain apparently simple solutions that we need to be wary of. Many doctors and hospitals and some Members of Congress want the tax cap on medicaid benefits. One employer response could be to hire their own physicians and build their own facilities: a response very good for many employers and very bad for many communities.

In closing, it seems to me that we ought to come to a mutual recognition that worker health is public health. They are not two separate subjects.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Goldbeck follows:]

Washington Business Group on Health

The Future of Fringe Benefits

Testimony Provided to the
Subcommittee on Taxation and Debt Management
Committee on Finance
U.S. Senate

by

Washington Business Group on Health

Willis B. Goldbeck
President

July 30, 1984

922 Pennsylvania Avenue, S.E., Washington, D.C. 20003 (202) 547-6644

My name is Willis B. Goldbeck. As President of the Washington Business Group on Health, it is my privilege to reflect for you the view, conditions and future concerns of our members. We are a small organization but, when it comes to a consideration of future fringe benefits it may be useful to note that some 50,000,000 employees, retirees and dependents receive their benefits through our member companies.

In addition to addressing the specific questions raised in your July 4, 1984 announcement I want to comment on two issues: the role of government in fringe benefits and the changing nature of work in America.

Government and Benefits

Deciding what government should do about specific private sector employment benefits is dependent upon achieving agreement -- or at least understanding -- on what the generic role of government should be. Since there are no well articulated rules to follow and precedent could offer solace to nearly any perspective one wished to defend, let me posit a few principles.

1. The federal government should stay out of private benefits unless one of its basic functions is called upon. These functions, other than defense, which is not relevant, are limited to:

    a. protection against discrimination by sex, race, age, nationality, religion or handicap

    b. maintenance of an equitable tax system

    c. protection of the public health

    d. accomplishment of the nation's social and economic objectives as articulated in law.

2. Government should lead, not follow, corporate America in appreciating trends and understanding future imperatives.

3. Government should intervene when the pace of private progress is inconsistent with the public good. A delicate balance is required to avoid interventions which stifle rather than stimulate.

4. Finally, government is the arbitration forum in which competing interests must be exposed, analyzed and appropriately compromised.

It is our view that each benefit issue brought to your attention should have to pass through the screen provided by these principles before you decide to intervene.

Fringe Benefits

Several benefit issues would successfully meet these criteria. Together, they represent an action agenda for 1984-85.

A. Reinstate the educational assistance deduction that included preventive, worksite wellness and health education programs. We appreciate Senator Packwood's leadership on this issue and urge the other members of Congress to join him in recognizing that improved educational and health status are investments which can contribute directly to the reduction of future dependency on government.

B. The Section 125 flexible spending accounts should not be allowed to expire next July. The concern of IRS for potential revenue loss is understandable. However, there is no evidence of what that loss will be. And, there is evidence that these accounts can achieve two significant economic objectives we share with Congress:

1. reduced medical expenditures

2. increased incentives for all workers to become prudent users of medical benefits

The latter can be demonstrated by the ALCOA, Xerox and Quaker Oats programs, among others. Quaker's 1983 results also prove the cost effectiveness, for the company, the worker and the government.

"Without a change, our plan costs for 1983 would have been about $1,745 per employee (a 20% increase over 1982 costs). Actual 1983 medical claims expense was $1,331 per employee. An average additional $76 per employee was refunded as unused health expense account funds and a dividend averaging $128 per employee was credited to the following year's (1984) expense accounts.

"Our plan achieved its objectives of reducing the rate of medical cost inflation and passing along savings to employees. It also resulted in reducing the company's tax deduction for medical care by $210 per employee and added an average of $76 per employee in taxable income. Both of these increased tax revenues."

We can protect against inappropriate use of these benefits by requiring a level of cost sharing as a criteria for eligibility. Firms using the Section 125 approach should be given a five year period to demonstrate the programs' impact. If negative, they can be stopped. If positive, they can be expanded. If we do not allow this demonstration period all we will have done is stifle cost management creativity and use our ignorance of the outcome to dictate policy.

C. We do not need a tax cap on medical benefits. As a method of reversing the trend toward poorly designed and excessive benefits, the cap might have been helpful eight years ago. Today it is not needed. This issue warrants three additional comments.

1. If you pass a cap, then exempt prevention (worksite wellness) programs so these will flourish.

2. Employer support for a cap is seriously undermined every time Congress and state government mandate new benefit coverages. Some of those mandates may be good policy but they are not consistent with the cap concept.

3. The strongest argument for a cap is the inequity of increasing tax support for worker benefits while decreasing tax support for care of the poor. A tax cap does not provide any guarantee of increased protection for the poor, only of decreased benefits for workers, many of whom are just above the poverty line themselves. We need new public-private programs for dealing with indigent care and for appropriately funding government programs like Medicare. There is little doubt that tax increases will be part of this process and we expect to pay our share. However, we are not convinced that a tax cap on existing benefits is either a guarantee of equity or a needed stimulus for better private sector cost management.

D. There is one item on which Congress can act that, while not a fringe benefit issue per se, will help all employers and unions manage their medical benefits. Title V of H.R. 5602, proposed by Congressman Ron Wyden, will assist all purchasers of care to more easily obtain and better manage provider-specific comparative utilization, price and quality data. That there is strong provider opposition for this measure is all the proof you need to know that the idea is valid. Congress wants to stimulate a more efficient medical market. So do our members. So does the public. So do the unions. So do the senior citizens. So do efficient and responsible medical practitioners. The only opposition to disclosure comes from those who either have something to hide, have no respect for the public's intelligence, or those who want implied governmental protection from competition.

E. Finally, Congress will inevitably be considering the issue of prefunding retiree medical benefits. This is an important issue which warrants your attention and calls out for a joint management-labor approach. Attached is our recent testimony to the House Select Committee on Aging, which we hope will be a useful reference. Let me add one caution: In the desire to protect against the rare cases of negated benefits do not write laws that will cause far more companies to simply drop their retiree medical benefits entirely.

In the private sector there has been a major change: the philosophy of medical benefits. Once viewed as compensation which should not be tampered with by employers, the medical benefit is now seen as a corporate financial asset which should be jointly managed with the employees. The result of this changing attitude is the creation of a new consumer, one not only provided with economic support for access but also with a combination of economic incentives and information that will facilitate selecting the right provider in the most cost efficient setting. As Congress considers fringe benefit legislation it must recognize this change and do everything possible to assist that new consumer -- at the aggregate corporate and individual worker levels -- to have accurate, timely and comprehensible information to stimulate the efficient medical market we all seek and know is attainable.

Changing Nature of Work in America

We urge the Congress to base your decisions about fringe benefits on a clear understanding of the society we are becoming rather than upon fond memories of what we were or even how we are today.

Any serious consideration of fringe benefits must be infused with an equally serious examination of the two essential ingredients upon which all benefit policies are based: workers and the nature of work itself. This is something that neither the public nor private sectors do very well. We have proven to be a very shortsighted society; quick to react and far too reticent to plan ahead.

A few facts make clear that the current rate of change has far outpaced our traditional reactive approach:

- more than 40 percent of the U.S. workforce is over 40 years old
- between 1960-80 the U.S. lost 39 percent of its share of world markets
- 70 percent of women between 25-39 are now in the workforce...twice the rate of just 25 years ago

- o Harris poll shows nearly 50 percent of today's retirees want to work...just think what the percentage will be in a 10 years

- o by 1990, the Medicare budget alone will be equal to the world's eighth largest national budget

- o the deficit and national debt are not just a mortgage against our future, they are reducing our current options, placing a drain on creativity and forging greater divisions among a population whose future is dependent upon unity

- o to prefund retiree medical benefits for just the "Fortune 500" would require an investment nearly twice that of the combined assets of all 500 of those firms

- o companies that, 10 years ago, had ten or more active workers for every retiree now have only two

Given these and many other equally harsh realities, we really need to accept the fact that this nation cannot, will not and should not financially support a retirement and medical benefit system in which people have a 20-40 year dependency at the very time when their experience can make them the most valuable members of society. Social Security, private pensions, Medicare and retiree medical benefits were a fine, humanistic concept for a 5-10 year period...which is the most they were designed for! The future of fringe benefits must not focus on protecting people <u>for</u> 20-40 years of inactivity. On the contrary; people needed to be protected <u>from</u> inactivity. Let government replace false expectations and dependency with support for healthy aging in a renewed economic and social system that recognizes and rewards the cyclical, rather than sequential, nature of education, work, and leisure.

We need a new ISM: neither Marxism nor textbook capitalism but rather creativism...the driving forces of middle class populist, peaceful, revolution that can have an impact of no less magnitude than the industrial revolution itself. The ingredients of creativism are already emerging, albeit neither well integrated nor articulated.

A work environment that contributes to creativism would have:

1. employee participation in management

2. profit sharing at all levels as a condition of employment, not a benefit

3. facilitation of healthy aging

4. ethnic, age and sexual diversity as a positive creative force

5. decentralized authority within a team cooperative concept

6. intrapreneurship: the rewarding of the entrepreneurial spirit <u>within</u> the corporation

7. family involvement; replacing the concept of workers and dependents with one of family units

8. job security, not meaning the same job but meaning the commitment to cycles of education and individual growth in an environment which is economically supportive rather than job threatening

These points are not a prescription nor are they to be relegated to a distant future. All can be found today as emerging trends which, good or bad, cannot be ignored. All will have major implications for the future of fringe benefits.

Creativism -- or whatever term you may wish to apply to these new forces -- is being accompanied by new legal dynamics in the U.S. workplace.

Workers are winning rights to a smoke free environment, to reject unsafe work conditions, to access employer financial information about issues of profitability and relocation. The traditional view of employment as a series of adversarial relationships is being countered by the success stories of industrial democracy. International workers' job security movements, as exemplified by the Vredeling Initiative of the EEC, Canada's Unfair Dismissal Statute and Norway's law to protect against job alienation are already having an influence here. A committee of the California Bar just issued a report supporting "just cause" standards and worker arbitration rights. Employees are becoming more aggressive about the investment of pension funds decisions; structural unemployment is on a curve that far outpaces even the most liberal jobs retraining program. The ability of the U.S. to be the unofficial benefactor of the third world's poor is undermined by the reality of population explosions in Africa and Latin America where growth is projected to exceed 65 and 44 percent respectively by year 2000. This compares to a population growth rate of less than 5 percent in Europe.

I mention these uncomfortable items because it is so important for you who are willing to take the lead in government to see clearly the magnitude of change with which we will have to cope. Fringe benefits must be made to reflect these emerging realities.

STATEMENT OF DR. DONALD BENTLEY, PRESIDENT, AMERICAN DENTAL ASSOCIATION, WASHINGTON, DC

Senator PACKWOOD. Dr. Bentley.

Dr. BENTLEY. Mr. Chairman, first of all, as president of the American Dental Association allow me to thank you for your previous efforts against proposals to levy tax on health care benefits, and also to commend you for scheduling these hearings on the general issue of fringe benefits and national tax policy.

And I would be remiss if I didn't call attention to words that I have heard before from my—I was going to say old friend, but that doesn't work right—it's long time friend—Senator, Senator Durenberger, from Minnesota. I think the many discussions we have had are moving in the right direction.

I'm not here to speak on the entire fringe benefit subject, but will, unless specifically requested to do otherwise limit my testimony to the health care field, with the emphasis on oral health.

All that has been written by economists, reporters, tax consultants, and others concentrates on Federal tax revenue problems and rarely alludes to the social and economic gains due to the encouragement of private sector health benefits for millions of employees and their families.

We in the health care field think this requirement is paramount. Experience and hindsight make clear that encouraging employer sponsored health benefit plans has been less costly, more efficient and has provided more choices and more innovations than any conceivable government financed and regulated system. I'm not suggesting that the system can't be improved and become more cost effective and efficient. And, in fact, this association has some suggestions in this area.

You see, I'm old enough to remember when dentistry, through stimulation from patients as well as talk of national health insurance, first entered the dental insurance field. Really, it's prepaid care because with 97 percent illness, it's not really insurance. But at that time, back in the fifties, you could not find an actuary or an actuarial firm that had any experience table relative to the coverage of dental care, and even more particularly, a group risk plan.

Consequently, we decided to employ copayment and deductible features in all our policies, something distinctly unique at that time. And this became a blessing in disguise because it did two things. It kept costs under control and it also provided a form of modified utilization control, both very cost effective.

Because of this, this discipline of health care, dentistry, can show statistically that for the past two decades the cost of oral health care has been at or below the CPI for all services. No other health care discipline can make this claim.

We think this system can be adapted to all health care systems, I realize that it is occurring, but it's little and it's slow.

Mr. Chairman, we in dentistry, figuratively speaking, wrote the book on this effective cost and utilization control system in the health care arena, and we would like to have the decisionmakers read it. Can the private sector keep up adequate standards of care if billions of support dollars are siphoned off to Federal tax coffers? We think not.

People needing oral health care receive next to nothing in help from medicaid and medicare. Yet from 1960 to the present, the membership in dental plans for employees has grown from 12 million to 90 million people. Even with this, however, as late as 1979 the National Center for Health Statistics estimated 6.1 million days loss of work per year due to acute dental conditions, still far too large a loss figure in production costs.

In summary, certain refinements are in order, but Federal tax policies have provided essential assistance and encouragement to make good health plans available to the vast majority of American workers. Withdrawal of this support might well be devastating and leave workers without adequate protection or require a more costly standardized Government program.

Thank you very much.

Senator PACKWOOD. Thank you.

[The prepared written statement of Dr. Bentley follows:]

ADA American Dental Association

STATEMENT ON

FRINGE BENEFITS

BEFORE

THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE

UNITED STATES SENATE

July 30, 1984

202/898-2400
Washington Office: 1111 - 14th Street, N.W., Washington, D.C. 20005

Mr. Chairman, members of the Committee, I am Dr. Donald E. Bentley of Hawley, Minnesota, President of the American Dental Association.

We commend the Chairman for scheduling these hearings on the issue of fringe benefits and national tax policy.

Recently published articles by certain economists, newspaper writers and others have concentrated almost exclusively on the tax treatment of fringe benefits in relation to immediate problems associated with Federal tax revenue collections. Little, if any, attention has been given to the counterbalancing long-term economic and social gains that have been achieved under existing tax policy in this area. It is our hope and belief that these hearings will provide solid documentation of the fact that it is in the best interests of this country to continue that policy which has successfully encouraged private sector coverage of health benefits for millions of employees and their families.

Historically, the development and growth of employee health benefit plans coincided with the following events:

(1) A public demand and need for mechanisms to allow families to budget health care expenses on a group, risk-spreading basis;

(2) extensive debate in Congress over legislation that would have established a universal, government-run compulsory health system;

(3) changes in the law regarding collective bargaining on employee benefits;

(4) the adoption of a tax policy that encouraged employer participation in benefit plans to promote better health for employees and their families.

Following upon, and related to these developments, of course, was the enactment of Medicare and Medicaid under which government assumed a major responsibility for direct assistance to the aged and the poor in meeting many, but not all, of their health care needs.

The result of the foregoing and many other related evolutionary decisions, actions and policies is a pluralistic, flexible health care system, which, for all of its problems and needed improvements, provides reasonably adequate protection for the great majority of Americans.

Whether that protection can be maintained, much less improved, if billions of supporting dollars are siphoned off and transferred from employee benefit plans to federal tax coffers is the question, as we understand it, under consideration here today. The answer, we believe, is that it could not. In our opinion, the withdrawal of the support and incentives provided by current tax law would reverse the progress toward adequate health insurance coverage in the private sector and lead directly to renewal of public pressure for greatly expanded government programs at much greater cost, lower efficiency and with regulatory mechanisms that could affect adversely the quality, selection and availability of health services.

In the case of our own interest which is to improve access to dental care and thereby improve the oral health of the public, a few pertinent facts and observations are:

The current tax law has encouraged coverage of employer-sponsored dental benefit plans for more than 90 million people.

- People covered by such plans are motivated to receive more preventive care than those not covered, resulting in better dental health and cost savings over their lifetimes;

- should such plans be dropped, alternative coverages would not be available since benefits must be offered on a group, rather than individual or family basis;

- the growth of dental benefit plans, which covered 12 million people in the 1960s as compared to over 90 million today, has not been accompanied by the high rates of inflation that have characterized costs of many other health services. In fact, dental care costs during this period have increased less than the rate of increase for all services as measured by the CPI, owing in part to the fact that dental benefit plans uniformly require beneficiary participation through copayments and other mechanisms;

- dental benefit plans make care available to many low income employees in contrast to Medicare and Medicaid which are almost totally deficient in this regard;

- better dental health results in higher productivity and consequent economic benefit to industry (National Center for Health Statistics estimated that in 1979 acute dental conditions caused 6.1 million days of work loss).

For the foregoing and many other reasons, we believe it is clear that Federal tax policies have appropriately and necessarily provided essential assistance in making health care benefits available through the private sector to millions of workers and their families. Alternatives either would leave many of these individuals without adequate protection or would require a costly, standardized federal program with minimal benefits.

While we fully appreciate the problems facing the Congress and the country because of the enormous Federal budget deficit, we do not believe that altering federal policies which have successfully encouraged the best protection against the costs of disease is a wise or proper approach.

We thank you for this opportunity to discuss this important issue with the Subcommittee.

STATEMENT OF CHERYL WESTPHAL, PRESIDENT, AMERICAN DENTAL HYGIENISTS ASSOCIATION, CHICAGO, IL

Senator PACKWOOD. Ms. Westphal.

Ms. WESTPHAL. Senator Packwood, Senator Durenberger, I am pleased to be able to appear and submit testimony today on the issue of fringe benefit taxation. I am Cheryl Westphal, president of the American Dental Hygienists Association. I represent 30,000 dental hygienists across the country. Dental hygienists are providers of dental care with a specialization in preventive dentistry. We are employees of both private dental offices, as well as larger dental centers and other private and public institutions.

Our association understands that the subcommittee wishes to develop a full, fair hearing record on current fringe benefit topics. As providers of preventive dental care, our statement for the July 1984 hearing focused on dental insurance and the importance of maintaining oral health care for more than one-third of the Nation's population who have employer paid dental insurance for employees and their families.

The Health Care Financing Administration has just reported the spending for dental care in 1984 should reach $23.7 billion. Only $1 billion of this amounts represent Federal, State and local government funds. Patients' out of pocket expenses totaled $15.8 billion, private dental insurance accounted for $6.9 billion. Expenses for dental care are expected to increase to approximately $31 billion in 1987 and to $39 billion by 1990. The proportion of this total generated through employer paid private dental insurance can be expected to increase, with such increases continuing through this decade. It appears possible that employer paid dental insurance could account for up to $10 billion of the estimated $39 billion dental expenditures in 1990.

As an organization which represents oral health specialists, it is logical that the American Dental Hygienists Association would encourage this committee to develop tax laws which encourage employers to provide fringe benefits, especially oral health benefits, for their employees. For the past 40 years, health care benefits have been an essential part of what is known as fringe care benefits, which are negotiated between labor unions and industry. And among these, beginning in 1954, was the dental prepayment insurance. Prepayment of dental insurance both preventive and restorative have been a fact of life for three decades and has led to a lifestyle that regards dental health as ranking in importance with general health and well-being.

As the American Dental Association has pointed out, dental insurance plans maintain the cost of dental care, and especially in our area of interest, preventive dental care maintains and reduces the cost of moneys spent on restorative care.

The Association recognizes the problem of fringe benefits, which the subcommittee is addressing in this hearing, and we are sensitive to the need in Congress to develop solutions to increase revenue in order to reduce the massive Federal deficit. It is our hope, however, that fringe benefits for health care, especially oral health care, will not be taxed. We know the committee and Congress will need to make agonizing decisions about which fringe benefits should be taxed and which should remain tax free.

It is our hope that Congress will opt for healthy Americans and healthy teeth and gums and save tax free status of the dental plan.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Ms. Westphal follows:]

The American Dental Hygienists' Association's Statement

on

Fringe Benefit Taxation

Presented to

The Senate Finance Subcommittee on
Taxation and Debt Management

The United States Senate

July 26, 1984

Introduction

Senator Packwood and members of the Subcommittee on Taxation and Debt Management, I am pleased to be able to appear and testify today on the issue of fringe benefit taxation. I am Cheryl Westphal, RDH and current President of the American Dental Hygienists' Association. My permanent residence is Totowa, New Jersey.

Comments on Fringe Benefits Taxation

The American Dental Hygienists' Association is pleased to have this opportunity to submit a record statement to the Senate Finance Subcommittee on Taxation and Debt Management on the issue of fringe benefits.

The Association represents approximately 30,000 dental hygienists who are specialists in the delivery of preventive dental care. The majority of the members of the Association practice dental hygiene in offices of private practice dentists but an increasing number practice in institutional settings which include nursing homes, long-term care facilities for the aging, special care facilities for the disabled and handicapped, correctional institutions, hospital dental clinics, dental hygiene and dental schools, community health centers, etc. As preventive oral health specialists, the role of dental hygienists is expanding substantially in reducing the incidence of dental caries and preventing the onset of periodontal disease.

The Association submitted a record statement to the Senate Committee on Finance in May 1983, addressing the proposed "tax cap" on employer-paid health insurance. The Association was concerned at that time that estimated income to be derived from a tax on health insurance would be used to finance a health insurance program for the unemployed which the Committee was also considering. The Association expressed deep concern that the linkage between the "tax cap" proposal and health insurance program for the unemployed be carefully studied before any action was taken by the Committee. We are pleased that the Committee did not act on either proposal and that now a record is being developed on the issue of fringe benefits generally, with a view towards developing tax policy that will be fair for employers and employees.

The Association understands that the Subcommittee wishes "to develop a full, fair hearing record on current fringe benefit topics" but, as providers of preventive dental care, our statement for the July 1984 hearing will focus on dental insurance and the importance of maintaining the oral health of more than one third of the nation's population who have employer-paid dental insurance for employees and their families.

The Health Care Financing Administration has just reported that spending for dental care in 1984 should reach $23.7 billion. Only $1 billion of this amount represents federal, state and local governments funds. Patients out-of-pocket expenses totaled $15.8 billion and private dental insurance accounted for $6.9 billion. Expenses for dental care are expected to increase to approximately $31 billion in 1987 and $39 billion in 1990. The proportion of this total generated through employer-paid private dental insurance can be expected to increase, with such increases continuing through this decade. It appears possible that employer-paid dental insurance could account for up to $10 billion of the estimated $39 billion dental expenditures in 1990.

Among the vast array of fringe benefits that will be considered during the July 1984 hearings, the Association will confine its comments to private dental insurance plans and urge that this fringe benefit remain completely tax free for employers and employees. The Association's rationale for urging that the status quo be maintained on dental health insurance plans was presented to the full Senate Committee on Finance last year and it is unchanged in 1984.

As an organization which represents preventive oral health specialists, it is logical that the Association encourage the Committee to develop tax laws which encourage employers to provide fringe benefits, especially oral health benefits, for their employees. For the past 40 years health care benefits have been the central part of what is now known as "fringe benefits" which are negotiated between labor unions and industry and among these, beginning in 1954, was included dental pre-payment insurance (the International Longshoremen's and Warehousemen's Union-Pacific Maritime Association and the west coast shipping industry).

The pre-payment of dental services, both preventive and restorative, has been a fact of life for three decades and has led to a life style that regards dental health as ranking in importance with general health and well-being. The 98th Congress recently passed the comprehensive debt reduction bill, leaving the proposal to tax health care benefits for the next Congress to consider and current law, which does not require that health care benefits be taxed, is still in force.

Do Employees Benefit Fairly From the Tax Incentives?

Dental benefit plans, according to the American Dental Association, help to control dental costs. Dental insurance rewards patients who take care of their teeth in order to avoid oral disease which would require expensive restorative care.

Major dental benefit plans, in most instances cover 100 percent of the cost of diagnostic and preventive treatment, which includes routine oral examinations, prophylaxis, fluoride treatment, pit and fissure sealant applications, x-rays, tooth charting and periodontic charting. All of these procedures, performed generally by dental hygienists in most dental offices, are preventive oral health measures intended to help patients avoid dental disease, such as dental caries and periodontia.

Most dental benefit plans are negotiated under the collective bargaining system between labor and management. While the plans may vary in dental coverage from industry to industry, they provide benefits fairly among the employees. Co-payment requirements in most dental benefit plans help to control the cost of dental services and encourage employees to care for their teeth. Failure to do so, with the co-payment features of these plans, requires more out-of-pocket expenses by employees.

Are Existing Benefits Effective in Encouraging Employer to Provide Them to Employees at a Lower Cost Than Government?

Earlier in this statement, we cited a current report of the Health Care Financing Administration on the nation's spending for dental care in 1984. It is significant that spending for dental care by federal, state and local governments was only $1 billion of a total annual expenditure of $23.7 billion. On the other hand, patients themselves spent $15.8 billion and dental benefit plans accounted for nearly $7 billion of the 1984 dental bill.

It appears that existing benefits for dental care do encourage employers to provide dental care at acceptable low cost levels, as opposed to providing benefits by governmental agencies. The provision of dental care under Medicare and Medicaid has been historically and traditionally minimal and inadequate.

Conclusion

The American Dental Hygienists' Association is a health provider organization and is unquestionably dedicated to providing preventive oral health services to the people of this nation. If the Association's goals and objectives to eliminate dental disease appear to represent a special interest group to the Subcommittee, we can offer no disclaimers or apologies. Our special interest is the promotion of oral health to all who seek it and need it.

The Association believes that taxing health care benefits, namely dental benefit plans, is an unhealthy idea which will defeat the great progress made by the dental hygiene and dental professions over the past three decades. The incidence of dental caries has declined and periodontal disease has become a focal point of treatment by the dental hygiene and dental professions. If oral health is a national goal and objective -- and the Public Health Service Surgeon General thinks it is -- we believe that dental benefit plans should remain tax free and that current statuatory law should not be changed.

Despite our bias in addressing the issues of fringe benefits, the Association recognizes that the Senate Finance Committee, and the Congress generally, are confronted with a dilemma. The plethora of fringe benefits is impacting on the nation's revenue base. Congress and the Executive Branch as well, are compelled to act. If revenues must be increased to offset deficits, it is apparent that the tax-free health insurance fringe benefit will be carefully scrutinized.

The Association recognizes the problem of fringe benefits which the Subcommittee is addressing in this hearing and we are sensitive to the need in Congress to develop solutions to increase revenues in order to reduce massive federal deficits. It is our hope, however, that fringe benefits for health care, especially oral health care, will not need to be taxed.

We know that the Committee and Congress will need to make some difficult decisions about whether fringe benefits should be taxed.

If the concept of taxation of employee benefits is accepted, the next step is to decide which ones to tax and which to allow to remain tax free. It is our hope that Congress will opt for healthy Americans and Americans with healthy teeth and gums and save the tax free status of dental benefit plans.

STATEMENT OF CAPT. ROGER A. BRUGGEMEYER, CHAIRMAN, RETIREMENT AND INSURANCE COMMITTEE, AIR LINE PILOTS ASSOCIATION, WASHINGTON, DC

Senator PACKWOOD. Captain Bruggemeyer.

Captain Bruggemeyer. I'm Capt. Roger A. Bruggemeyer, and I'm here today to address this subcommittee in my capacity as the Chairman of the National Retirement Insurance Committee of the Air Line Pilots Association, International.

The association represents a professional interest in more than 34,000 pilots and collective bargaining units with 45 airline carriers. The association's collective bargaining is conducted separately with respect to pilot groups with the result that the association members are covered by 45 separate collective bargaining agreements. Each of our pilot groups has depended upon the present system of Federal taxation and tax deferral as it relates to pension plans, life and health plans and associated vehicles such as VEBA's. Each group has sought an understanding with its employer, who in turn has relied upon the current intent of the law in reaching agreement to protect all of its employees. To change now would have a very serious and destabilizing effect upon all of the working men and women who have had faith that the benefit system would continue to function as promised.

Airline pilots have been victims of similar cutbacks in the very recent past. TEFRA reduced the benefits and funding levels applicable to some of our members' defined benefit plans, plans that had been specifically designed to meet the unique needs of our members. As you are aware, commercial airline pilots are required by the Federal Aviation Administration to retire at age 60. However, TEFRA treated our normal retirement age of 60 as an early retirement, requiring a reduction from the maximum permissible benefit available to all other employees at age 62. This also requires a reduction in the funding level applicable to such plans.

TEFRA is a hard example of sudden change. And the association wishes to see stability in the benefit system; not erosion in the name of deficit reduction. The Congress must obviously address the issue of raising Federal revenues, but it must also address the question of why certain employee benefits were encouraged through congressional tax incentive avenues. In our case, benefits have been collectively bargained to provide an integrated package of economic security. They are balanced to meet the needs of employees while at the same time meeting the employer's indirect compensation objectives. These needs and objectives include the provision of an adequate standard of living for the employee and his family, recognition of outstanding employee performance, protection against liability for ordinary and extraordinary medical expenses, protection against loss of income, in the event of the employee's premature death, disability and unemployment, and the provision of adequate retirement income, especially when the Social Security system is confronted by major problems that might disturb its long-term effectiveness.

And, additionally, an important national objective is achieved in according tax exempt status to employee pension benefit trusts by providing a vehicle for accumulation of significant portion of this country's available investment capital. To place a cap on the dollar cost of health premiums is particularly vexing. This will cause decreases in the number of employees covered by heal'h programs and will reduce the care now available to those who need it. The burden of paying for the lost health benefits will fall directly on those who can least afford to augment the lower care level.

The previous attempt of such a regressive move was defeated by Congress. Your leadership, Mr. Chairman, in helping to defeat that past proposal is sincerely and deeply appreciated, and we only hope that you shall continue to support the working force.

By encouraging the private system through tax incentives, base regulations as a primary burden of providing economic security to the retired sector shifted away from the individual to help prevent financial calamity, but also away from the Federal and local government as well. As Congress has so clearly recognized in the past, it is really in the national interest not to disturb the balances that have been created by the present tax treatment of employee benefits.

The association firmly believes Congress should continue to foster provisions that provide for adequate retirement and health security. The association strongly opposes the efforts of those few Members of Congress and the Treasury Department who would diminish or eliminate the promises of the past.

We will submit more detailed testimony in writing. And thank you, Mr. Chairman, for this time.

[The prepared written statement of Captain Bruggemeyer follows:]

STATEMENT OF

Captain Roger A. Bruggemeyer, Chairman

National Retirement and Insurance Committee

Air Line Pilots Association, International

before the

Subcommittee on Taxation and Debt Management

Committee on Finance

U.S. Senate

July 30, 1984

Taxation of Employee Benefits

I am Captain Roger A. Bruggemeyer, and I am here today to address this subcommittee in my capacity as Chairman of the National Retirement and Insurance Committee of the Air Line Pilots Association, International. The Association represents the professional interests of more than 34,000 pilots in collective bargaining with 45 airline carriers.

The Association's collective bargaining is conducted separately with respective pilot groups, with the result that the Association members are covered by 45 separate collective bargaining agreements. Each of our pilot groups as they bargain, has depended upon the continuation of the present system of Federal taxation and tax deferral as it relates to pension plans, life and health plans and associated vehicles such as VEBAs. Each group has sought an understanding with its employer, who in turn has also relied on the current intent of the law in reaching an agreement to protect all of its employees. To change now would have a very serious and destabilizing effect

Additionally, an important national objective is achieved in according tax exempt status to employee pension benefit trusts by providing a vehicle for the accumulation of a significant portion of this country's available investment capital.

To place a cap on the dollar cost of health premiums is particularly vexing. This will cause decreases in the number of employees covered by health programs, and will reduce the care now available to those who need it. The burden of paying for the lost health benefits will fall directly on those who can least afford to augment a lowered care level. The previous attempt of such a regressive move was defeated by Congress. Your leadership, Mr. Chairman, in helping to defeat that past proposal is sincerely and deeply appreciated, and we only hope that you shall continue to support the working force.

By encouraging the private system through tax incentive base regulations, the primary burden of providing economic security to the retired and sick is shifted away from the individual to help prevent financial calamity, but also away from the federal and local governments as well. As Congress has so clearly recognized in the past, it is really in the national interest not to disturb the balances that have been created by the present tax treatment of employee benefits. The Association firmly believes Congress should continue to foster provisions that provide for adequate retirement and health security. The Association strongly opposes those few members of Congress and the Treasury Department who would diminish or eliminate the promises of the past.

Due to the time constraints, we shall submit a more detailed explanation of our concerns in the near future.

Thank you, Mr. Chairman, for this time, and I stand ready to respond to any questions that you may have.

upon all of the working men and women who have had faith that the benefit system would continue to function as promised.

Air line pilots have been victims of similar cutbacks in the very recent past. TEFRA reduced the benefits and funding levels applicable to some of our members defined benefit retirement plans. These plans had been specifically designed to meet the unique needs of our members. As you are aware, commercial airline pilots are required by the Federal Aviation Administration to retire at age 60. However, TEFRA treated our normal retirement age of 60 as an early retirement, requiring a reduction from the maximum permissable benefit available to all other employees at age 62. This reduction also requires a reduction in the funding level applicable to such plans.

TERFA is a hard example of sudden change, and the Association wishes to see stability in the benefit system; not erosion in the name of deficit reduction. The Congress must obviously address the raising of federal revenues. But, it must also address the question of why certain employee benefits were encouraged through Congressional tax incentive avenues. In our case, benefits have been collectively bargained to provide an integrated package of economic security. They are balanced to meet the needs of employees while at the same time meeting the employer's indirect compensation objectives. These needs and objectives include the provision of an adequate standard of living for the employee and his family, recognition of outstanding employee performance, protection against liability for ordinary and extraordinary medical expenses, protection against loss of income in the event of the employee's premature death, disability and unemployment, and provision of adequate requirement income,especially when the Social Security system is confronted by major problems that might disturb its long term effectiveness.

Senator PACKWOOD. Captain, I wish it was only a few Members of Congress. It is the majority of the Ways and Means Committee at least. It's always a touch and go fight on the Finance Committee and it is the absolute heart and soul, unfortunately, of the Treasury Department. They are opposed to the tax free nature of these benefits. I don't know if they just don't want them provided. They never come and testify in that fashion. But they certainly want them taxed and that is where the devil takes the consequences as to what may happen if they are taxed. The evidence we have seen laid out here today by them is that some of them are going to be cut back. No question about it. Some of them are going to be cut off. No question about it. And we will be back at picking them up.

Dave?

Senator DURENBERGER. There is one other element tc add on and that is all the people that are buying Bill Bradley's book on the notion that somehow or another all we have to do is put a 14- or 26-percent tax on everybody's income and eliminate all the loopholes. Well, what you would eliminate is the whole purpose of having this hearing. I mean it would be gone. Forget about it. So there is a tremendous amount of pressure on this system, largely, from people, as we are illustrating in these series of hearings, that haven't quite come to the conclusion that there might be some good in a sensible tax code. And maybe we have done some good things in the past.

I hope that if you expand your testimony, any of you, that one of the things you would give a little thought to—and I see where everybody stands on the tax cap. Obviously, I do support that but for some different kinds of reasons. The thing that is of greater interest to me is how we might condition access to this large amount of tax expenditure that exists here. Whether it's the deduction or the tax free income.

We, in the public sector, haven't really put any requirements back on the system. One of them that comes to mind, of course, is continuity of coverage. And we talk about what happens when a member of the family reaches age 18 or 21, whatever it is, and they are out of the plan; what happens in the case of a divorce or dissolution of the marriage? Out of health care coverage.

You look across the unemployed or uninsured in America and there are a whole lot of people that are not in the medicaid category. They are people who unfortunately through circumstanes usually beyond their control have missed what they could have been provided somehow through the employment system.

So I hope that as each of you continues your participation in this process that you might look at a better way for us to look at this system than just putting caps on or something like that. Tell us how we might, in effect, condition this $35 billion a year in revenue foregone even though we are doing it unfairly across parts of the country and unfairly across income levels. Maybe there is some good cost sharing and continuity and catastrophic and those sort of features. So as you go back to your associations, Mr. Chairman, I think it would be helpful to all of us to get that kind of a feedback into this process as well.

Senator PACKWOOD. Ms. Goldfarb, I thought the point you made about Title 20 was a good one. There are people who simply fall between the cracks who are unemployed. It's not their fault they fall between the cracks, and they are going to be covered. I suppose the Government could work out a Government paid insurance system that would take care of them. If not, we are going to take care of them directly. And that is a legitimate function of Government and a legitimate concern.

Thank you very much. We have no more questions.

Senator PACKWOOD. Next is a panel consisting of Paul Jackson, vice president, the Wyatt Co.; Gerald Facciani, president of the Professional Plan Administrators; Ed Delaney, chairman of the American Bar Association; and Carl Mammel, president of the Association for Advanced Life Underwriting.

STATEMENT OF PAUL H. JACKSON, VICE PRESIDENT, THE WYATT CO., WASHINGTON, DC ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Senator PACKWOOD. Mr. Jackson.

Mr. JACKSON. Thank you, Mr. Chairman. We very much appreciate the opportunity to present the views of the National Small Business Association and the Small Business Legislative Council. With me today is Mr. Herbert Liebenson, who is president of the National Small Business Association.

The Small Business Legislative Council has now grown to represent 82 national trade associations with small business interests, and the combined membership of 4½ million enterprises represents more than one out of every four business firms of all types in the country. This group accounts for about 40 percent of the total gross national product, creates about half of all industrial innovation, and is responsible for a major percentage of the new jobs in our economy.

We have a prepared statement, which I think is far too long to try to read. I would like to emphasize a few points in it.

In coming into the building this morning, I couldn't help but be impressed by the extent to which our society is dominated by the lunatic fringe. My umbrella had to be photographed to let people know that I wasn't bringing in dangerous items. Thirty years ago that sort of thing didn't happen. Thirty years ago, however, in the group life insurance field there were a few lunatic fringe employers who were providing a thousand dollars of insurance for all of their employees but because of the tax break, the president would get himself $100,000 of insurance. Those programs have now been controlled. They were controlled to some extent by State laws limiting maximum amounts of life insurance. There are antidiscrimination rules that the Federal Government has imposed on almost all of these group insurance plans. And with the exception of the fussiness, the detail, the difficulty that many small businesses have with rules like the TEFRA provisions for top heavy plans, these generally have worked. And they have eliminated the abusive plans.

What hasn't worked too well, in our judgment, are the incentives. And they haven't worked for a couple of reasons. First, there is a host, at this point, of thousands upon thousands of highly educated skilled tax practitioners who are bound to look at whatever

Congress writes, however tightly you try to button anything up—these people are out there to make use of these plans in a tax efficient manner. This is their business. They do a fine job of it. And they outnumber you probably 100 to 1, so it's no wonder that legislation simply can't keep up with it.

Second, incentives have encouraged first dollar coverage. For example, dental insurance, vision care, legal insurance, and so on. On the other hand, the lack of incentives has discouraged coverage like group survivor income coverage, group life insurance, where taxing amounts over $50,000 has effectively limited the amount of coverage in many cases to $50,000. That amount was set in the early 1960's, and a lump sum of $50,000.00 will provide a widow aged 50 with a monthly income indexed by cost of living of approximately $150. I doubt very much that Congress feels that $150 a month is a good limit to impose on this.

Finally, government, when it injects itself through tax incentives, tends to design the program. Government design gets complicated. There are hundreds of pages of regulations that small business simply can't read. Many of these things are ignored or the coverage simply isn't put in. So at the very least whatever is done, we ought to try to keep the system simple so that it can actually be complied with by the many small businesses.

Thank you.

[The prepared written statement of Mr. Jackson follows:]

Statement of

Paul H. Jackson
on Behalf of

THE NATIONAL SMALL BUSINESS ASSOCIATION

Submitted to the Subcommittee on Taxation and Debt Management
United States Senate Committee on Finance
Holding Hearings on Tax Policy and Fringe Benefits

July 30, 1984

The National Small Business Association (NSB) is a multi-industry trade association representing approximately 50,000 small business firms nationwide. The NSB sincerely appreciates the opportunity to present the views of small business on fringe benefits and tax incentives.

Small business is most important to the U.S. economy. Small business generates a disproportionate share of new jobs, new processes, new inventions. Small business is where the action is. Many thousands of small businesses are established each year and at the time of founding, these businesses probably have an expected future of only four or five years on the average. Many small companies fall by the way in a year or two, but a few go on to become giants.

The characteristic most important to today's topic is that small businesses must rely on benefit programs more heavily than large companies because their shakier future requires a demonstration of soundness in the delivery of employee benefits. Furthermore, small businesses have minimal clerical forces and administrative facilities, so that government rules and regulations fall more heavily on them than they do on corporations which are large enough to have staff experts who specialize in employee benefits and the laws and regulations controlling them.

Over recent years, federal regulations have tended to be unfairly discriminatory. One illustration is the Department of Labor regulation on Qualified Plan Asset Managers (QPAMs). Here certain organizations are considered qualified to manage plan assets if they meet minimum size standards. Otherwise, substantial tests are required.

Another illustration is the top-heavy requirement in TEFRA. Because of the complexity of the rules and the confusion that is raised in the minds of employees, the larger firms where the rules are not expected to apply have asked to be given a free ride. If this should happen, the top-heavy rules, like so many others, will be applied only to small business. We deplore this type of regulation. We deplore the mindset on the part of certain government regulators that smallness somehow implies a greater possibility of wrongdoing, and therefore stricter rules are needed but only for smaller organizations.

This hearing is focusing on a number of interesting questions that delve into the relationship between tax incentives and fringe benefits. While it is common today to view the existence of generous group insurance plans such as group life insurance, medical expense insurance, disability income insurance, accident insurance, and the like as having developed by reason of the tax incentives that are offered by government, it is clear that in every instance the benefit plans came first and the tax incentives did not show up until a later date. For example:

- hundreds of employee benefit associations were established between 1905 and 1910, and yet the formal tax code treatment for such plans was not introduced until the 1942 Code.

- Group life insurance was developed in 1911 and had spread to many companies before a Solicitor General tax ruling in the 1920s held that the employer could deduct the cost and the employees would not be currently taxed on income.

- The first pension plan was established in 1875 and a reasonably thorough set of tax incentives was not included in the Code until the 1920s.

Employee benefit plans are adopted because they are needed by employees and because employers feel an obligation to make some provision for those needs. Employee benefit plans designed to meet widespread needs develop before there are any tax incentives intended to encourage such programs.

As a general principle, we believe that the primary purpose of the Tax Code is to raise sufficient revenue to operate our government. Clearly that revenue should be raised in such a way as to minimize distortions, inequities, and unfair treatment of various groups. The concept of collecting more tax from people with more money through a progressive income tax scale is essentially a tax raising consideration rather than a solely social one. It's easier to collect more from somebody who has more.

We believe that incentives offered in the Tax Code deliberately, in order to encourage private citizens to act in one way or another, have proliferated beyond the desirable point. Furthermore, they tend to encourage the development of benefit programs that maximize tax advantages rather than programs that meet employee needs. First-dollar health insurance, routine dental coverage, vision care, legal benefits, etc., all developed because a tax incentive was offered. Indeed, the tax incentive encourages such programs to pick up all routine expenses that every employee has since there is then no redistribution, just tax breaks. Anyway, at this stage we should be considering minimizing such tax incentives.

The government now believes that by reason of offering a tax incentive or collecting a lower tax than otherwise might have been collected, the same degree of government monitoring is required as if government actually collected the tax and then spent it on various programs. Thus, tax incentives encourage a central government to inject itself in ever more detail regarding the conduct of daily life on the part of citizens and businesses. Our society is a pluralistic one and the small businesses have a wide range of employee benefit plans because the needs of their employees and of those businesses vary widely. Such benefit design decisions in the private sector are made only after a "benefits/cost analysis". Centralized benefit design by Congress, on the other hand, is usually based on a "benefits only analysis" because no direct federal expenditure is involved. This is grossly inefficient and basically unamerican. We advertise ourselves as a "free society" and yet by virtue of these regulations and rules issued to monitor tax incentives, we find government injecting itself as a benevolent uncle with costly ideas as to how private groups should be spending their own money.

Tax incentives are deviations from normal tax policy intended to encourage certain behavior. We are not even clear as to just what normal tax policy is. Some of the principles that we followed for many years are now being eroded. For individuals, the personal income tax once was on a strictly cash basis for the reason that added taxes will apply to an individual only after he has received the added funds which have been taxed, and therefore has the cash available to pay the tax.

In recent years there has been much talk about taxing each employee on the investment yield of a pension fund or on the employer contribution to that fund. This runs counter to the cash principle since the employee would not have any added income to pay the tax over and above that income which was used to develop his base income tax liability. Other "imputed income" of this sort is the value of parking in a company lot, the value of the protection received from a group life insurance policy greater than $50,000, the imputed rental value of an owner-occupied home, and a host of others. All of these are considered desirable because they broaden the tax base. All of them fail the cash test. It is somewhat ironic that many of these suggestions for taxing an individual can easily be considered the normal tax policy so that failure to tax on that basis becomes a tax expenditure.

In the good old days before ERISA, when employer pensions were less secure than they are now and in some instances forfeitable up to the date the employee was eligible to retire, there could have been no imputed tax because of the substantial risk of forfeitability. Congress, by enacting ERISA, forced employers to increase the certainty of benefit delivery by use of minimum vesting standards. Nowhere in the description of ERISA, however, can the sponsors of the legislation be found to be taking credit for any increased vulnerability to taxation. Maybe some employees would prefer less secure pensions and no current tax liability.

One of the current pressures to generate greater tax revenue is due to the substantial deficits projected in the next few fiscal years. In theory, this government deficit must compete against private interests in borrowing from the funds available for investment. Therefore, the greater the deficit the greater the pressure on interest rates and the greater the likelihood of an imminent recession. If this is the reason we wish to balance our budget, it would then be rather dumb to try to tax pension funds directly. Each $1 taken from a pension fund and paid to the federal government will reduce the deficit by $1 and will simultaneously reduce the funds available for investment by $1. The process is clearly one which has no impact whatever on relieving the pressure of too many borrowers seeking too few funds. Indeed, by discouraging the adoption and expansion of pension or savings plans, in short order such a tax would result in a greater reduction in funds available for investment than the reduction in deficit and actually make matters worse.

When government attempts to do something directly, it succeeds only to some degree. When it attempts to do something indirectly, it almost always fails totally and achieves the opposite result. Milton Friedman illustrated this point by stating that the man who was once underpaid at $1.00 an hour is now unemployed at $3.50 an hour. Incentives often produce the wrong response.

There have been periods in our history where personal income tax rates have reached almost confiscatory levels. We also have a famed Supreme Court justice stating that no citizen is obligated to pay more tax than the minimum required under the law. As a result, we have an entire industry composed of thousands upon thousands of bright, imaginative and well-paid individuals whose occupation consists of minimizing the taxes for their customers. Whenever tax incentives are offered, this group of tax practitioners invents and develops new devices to take advantage of the incentive with or without carrying out the intent of Congress. The pressures are somewhat less by reason of the recent reductions in personal income tax rates, but the army of tax practitioners is already there, fully developed and prepared to support itself on whatever new legislative changes are introduced.

One more illustration of tax incentives should be mentioned. From its beginning, group hospital/surgical/medical insurance has stood in a favored tax position because the benefit recipients are sick people and it seems unreasonable to impose a tax on monies paid simply because of their misery. Whatever the reasons, for the last 50 years employers have been able to pay premiums for group health insurance and deduct them from corporate income for tax purposes. The employee has not been asked to pay income tax on the premiums paid nor has he been asked to include the benefits paid in his income subject to his right to a standard medical expense deduction. Unlike the pension area, this is a case where the tax is never collected. Whether or not this tax incentive is responsible, medical plans have developed over the last 50 years from plans providing only partial protection against a few major expenses to plans which provide almost 100% protection against hospital, surgical and doctors' bills. At the same time we now face a terrible national problem with health care costs rising at unsustainable rates. Thus many of these programs, for cost reasons, are being redesigned so as to cut back on first-dollar protection. It is quite possible that tax incentives have been responsible for this predicament.

The basis for government control is that tax incentives are viewed as the equivalent of collecting the full tax and then paying it back -- i.e., tax expenditures. This is a concept that was first developed in the late 1960s and incorporated as part of the budget procedure in the 1970s. Basically, the concept itself is flawed and the numbers are really phonies, and yet they are used as though they indicated an amount of tax collections that could be expected if the tax law were to be changed. The first problem with the tax expenditure concept is that it ignores second order effects, namely, if the tax law is changed, then people change their patterns and procedures. The British philosopher, Herbert Dingle, once posed the query, "What would be the color of an elephant's eggs if an elephant laid eggs?" In large part, a tax expenditure is a Dingle query, "How much tax would have been collected if we had had a tax law different from the one we now have, but everyone behaved as though we didn't?"

Apart from their basic flaws, the tax expenditure numbers are not even comparable from year to year. A part of the growth in tax expenditures for private pensions, for example, from 1980 to 1983 included in one year the addition for the first time of state and local government plans and in a second year, a grossing up to put the tax expenditure on an "outlay equivalent" basis (which may be a concept having even greater flaws than the tax expenditure concept). The point is that Senators and Congressmen should not look at the tax expenditure numbers they are given as being representative of taxes that are being spent by the government, or of taxes that could be collected if the government changed the tax laws. The numbers can be made as large or as small as the person responsible for the calculations wants them.

By reason of the recent substantial increase in tax expenditures, many in government have felt that this calls for an increasing role on the part of the federal government in the determination of many details regarding employee benefit plans just because taxes could have been collected if we had had a different tax law. This has led to a tremendous increase in the complexity of the laws and regulations relating to these coverages. This complexity is particularly burdensome on small businesses. Thirty years ago, the entire tax treatment of group life insurance was covered by a simple Solicitor's Opinion in 1920. Now we have Section 79 rules and regulations that are almost impossible for a small business to understand and apply. They are probably honored more in the breach.

For survivor income plans the complexity is such as to simply discourage coverage entirely. When survivor income coverage is involved, the small employer providing this income to surviving spouses is supposed to determine the actuarial value of that coverage at the beginning and end of each of the 12 months in the course of a calendar year based on the spouse's age and on the employee's age and pay in order to determine the average monthly excess to which the Section 79 table is to apply. Just describing this suggests that it is so complicated that those few small businesses which have this highly desirable coverage either ignore the calculation because they have never heard of it, or they do it wrong.

Another illustration of the complexity is the pension area, where the passage of ERISA, MEPPA and TEFRA have gotten us to a point where the laws and regulations relating to the tax and labor aspects of these plans are now contained in books so large and cumbersome that only a handful of experts in the United States can truly be said to be expert in the entire field. One cannot establish a plan by just calling in one individual. The large plans call in a half dozen or more to make sure they are following the rules. Rules for these plans are issued by the Internal Revenue Service, Department of Labor, PBGC, EEOC, Department of Justice, and Joint Board for Enrollment of Actuaries. It took 300 pages to spell out all the rules relating to the crediting of service. The rules relating to the rehiring of a retired worker are so complex as to defy description. The small businessman does not have a staff so large that an entire section can be devoted to employee benefit plans and all the federal rules that apply to them.

What is the effect of all this regulation on fringe benefits? Group life insurance at one point was offered without restriction. It grew rapidly. In the 1950s, coverage spread to most groups. By 1960, tax consultants had found a great loophole whereby a group could provide $1,000 for all employees and $100,000 for the President. Partly due to such abuse, in 1962 Congress required that coverage be non-discriminatory and established a $50,000 limit on the amount of coverage that could be provided without tax.

Section 79 requires the employer providing amounts in excess of $50,000 to determine the excess each month during the year, apply the Section 79 tax table, and report the imputed income at year end. The amount of tax that is actually raised by this rule is fairly small, but the amount of fuss and bother involved is significant. More to the point, many small employers stop their coverage at $50,000 in order to avoid the tax calculations. And what will $50,000 provide today? A widow aged 50 who is given $50,000 in cash can be given a monthly benefit indexed by cost of living and payable for the rest of her life of about $150 a month. Surely Congress does not believe that $150 a month is the most that should be provided to a widow without jumping in with tax complications. In any case, most group life plans carried by small businesses limit the amount of protection to $50,000 except for a handful of key people. Quite probably many small companies that do provide more than $50,000 are unaware of the tax and do not go through the complicated calculations.

A second illustration of the effect of tax incentives is the historical developments in group permanent life insurance. Group paid-up life insurance was developed because of a tax problem with an employee benefit association in 1940. Group paid-up is a sound group insurance product with cash values for the retiring or separating employees. When tax rules were finally developed to permit this form of coverage, tax practitioners encouraged insurance companies to develop other forms of group permanent life insurance which would take even greater advantage of the tax laws. The end result was that the IRS had to expand Section 79 in order to control the unreasonable proliferation of these tax avoidance schemes.

Yet another illustration is the voluntary employee beneficiary association which historically preceded group life insurance as a means of providing benefits to an employee group. Once the tax practitioners found this product out, the 501(c)(9) trust was used by major organizations as a tax avoidance device. Most of these VEBAs are not "voluntary" and there is no employee association involved at all. Here again, practitioner abuse led us to the point where legislative action was necessary to control it. The Tax Reform Act of 1984 is not easy reading and very few small businesses will be able to avail themselves of the tax incentives for VEBAs.

Retired lives reserves originated as a means of making retiree benefits more secure. Generally they operated in a reasonable manner until the tax experts discovered that it could be used as a means of avoiding tax. Similarly, reimbursement accounts developed under the cafeteria plans were pushed closer and closer to the line by tax practitioners until the so-called "zero balance accounts" were developed. These are nothing more than a device to obtain a medical expense deduction without the 5% barrier that all other private citizens have to contend with. Clearly, one reason that tax incentives are inefficient is that tax experts continue to refine and distill new benefit plans and programs until they achieve maximum tax efficiency, and this means isolating and discarding many of the elements of protection that Congress is trying to encourage.

To summarize, we believe that the more Congress tries to control the details of individual employee benefit programs through tax incentives, the greater the proliferation of tax practitioners, tax avoidance schemes, and tax abuse. Furthermore, our society loses the advantage of many of our brightest young people to an occupation which does not serve to increase the supply of goods or services available to our country. One of the best paying occupations of the present time for brilliant people is the minimizing of taxes under a Code which is so complex as to defy analysis by the average citizen or business.

We now have some $10 billion annually being paid into group life insurance plans and we are taxing employees on the estimated value of the benefits in excess of $50,000. We collect insignificant revenues by this abnormal tax but we inhibit the growth of group life insurance and of survivor income insurance. Even worse, we leave our society in a position where more and more reliance must be placed on the survivor income protection under the Social Security program. As a revenue enhancer, the taxation of group life amounts over $50,000 must be considered to be a total failure. And the limit set in 1964 will, as we go on, affect a greater and greater percentage of the work force.

The Tax Code is a means whereby the government raises the funds necessary to operate. It should be designed so as to raise those funds in an efficient and fair manner. Just because there are very few rich people, Congress should not allow itself the pleasure of imposing heavy taxes on them which raise little revenue but which sound good on the campaign trail. Similarly, just because employee benefit plans are an integral part of the employment relationship today and affect millions of people, Congress should avoid the temptation to try to design benefits for everyone in the country through the process of offering tax incentives or tax penalties. In general, the government's rules intended to prevent discrimination in amount or availability of benefits are too fussy and detailed, but they have worked. On the other hand, such rules should be viewed as limits beyond which plans become so bad that they should not be permitted. The current rules disqualify many plans that, on balance, would make a positive contribution to our welfare.

We should have a stable tax system that changes infrequently and predictably if we are to encourage long-term programs that meet employees' needs. We should have a tax system that taxes not the promise to pay future benefits, but the future benefits that are paid if we are to avoid inequity. We should have a tax system that taxes actual income, not imputed values.

If we have a tax system that is perceived as fair, we can avoid abuse. If we have a tax system that is not impossibly complex, it will not be ignored. If we have fewer government rules on how employee benefit plans should be designed, we will have greater freedom to design those plans to meet the real needs of small business and its employees.

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STATEMENT OF GERALD D. FACCIANI, PRESIDENT OF THE PROFESSIONAL PLAN ADMINISTRATORS, INC., CLEVELAND, OH

Senator PACKWOOD. Mr. Facciani.

Mr. FACCIANI. I appreciate the opportunity to testify this morning as a small businessman on the subject of fringe benefits. I am president and owner of a small business in Cleveland, OH. Our firm employees 14 full-time people, 12 of whom are female. We sponsor a variety of fringe benefit programs such as one, 401(k) profit sharing plan; two, group term life insurance; three, accidental death and dismemberment insurance; four, short-term disability insurance; five, medical insurance; six, medical expense reimbursement plan for expenses incurred of up to $2,500 per year per employee; and, finally, a dependent care assistance program for expenses incurred of up to $2,500 per year per employee.

These formal benefit programs are provided in addition to vacations, holidays, sick leave, and continuing education programs. And employees across all pay and service levels can and do participate equally in our benefit programs.

Clearly, however, our employees at lower compensation levels benefit much more from these programs than higher compensated employees. The firm sponsors these benefits for a number of reasons. One, we want our employees to work in an atmosphere conducive to productivity and professionalism. Two, we want our employees to know the company cares about them. Three, we want long service employees and we feel these programs help attract and retain high quality personnel. And, four, the company cares about the financial well-being of its employees and their families and it wants to support the financial integrity of those families.

Every one of our benefit programs, except disability, has been used by our employees. And these programs have literally made the difference in several situations where our employees' husbands were temporarily unemployed or laid off. These are the employees who appreciate the dignity such benefit programs can offer. And these are the employees who would suffer most if such programs were terminated.

The tax deductible nature of these programs allows us to support them. If current benefit levels were not deductible in toto, the benefit plans of our company—and I feel the majority of small businesses—would be scaled back or terminated. This could result in the federal Government spending more money to provide supporting benefit programs.

In summary, our fringe benefit plans have been installed to benefit everyone. The benefit program is very essential to the economic security of our employees. If such programs were terminated by us, the burden would fall most heavily on our female, middle income earners. Not only would their benefits contract, but also their ability to save money and thereby promote much needed capital formation in America would diminish proportionately. For example, our sponsorship of these benefit plans in no small measure accounted for the 9.6-percent average contribution rate of our lower paid two-thirds employees to our 401(k) plan.

Our employees applaud the thought that went into the development of all the plans available to them. Not to have these fringe benefits available for sponsorship would mean lower employee morale, less flexibility for employees within a changing demographic scenario, less stability in budget planning, and more instability for those small businesses which support such programs.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Facciani follows:]

STATEMENT

IN CONNECTION WITH HEARINGS OF SENATE FINANCE SUBCOMMITTEE

ON TAXATION AND DEBT MANAGEMENT

ON THE SUBJECT OF FRINGE BENEFITS

JULY 26, 27 and 30, 1984

by

Gerald D. Facciani
President
Professional Plan Administrators, Inc.
Cleveland, Ohio 44131

(216) 447-1694

I appreciate the opportunity to provide testimony on the subject, and I welcome any questions regarding my written testimony. Professional Plan Administrators, Inc., is a small business located in suburban Cleveland, Ohio. The purpose of this testimony is to provide information on employee benefit plans sponsored by our company and to focus on the importance of such programs to our business and our employees. This statement will explain the various benefit plans sponsored by our company, why we provide such benefits, the tax treatment of such benefits, and why such plans are cost-effective for our company and our employees.

Professional Plan Administrators, Inc. is a fee-for-service benefit consulting firm. The firm presently employs 14 full-time employees, 12 of whom are women and 2 of whom are men. Our company offers the following formal benefit programs:

-**Profit Sharing/401(k) Plan.** Immediate eligibility on February 1 each year for full-time employees at least age 21 with 100% immediate vesting.

-**Group Term Life Insurance** equal to one times total annual compensation, not in excess of $50,000. Eligibility for Group Life Insurance is 30 days of employment.

-**Accidental Death and Dismemberment Insurance** equal to the amount of Group Life Insurance. Eligibility for Accidental Death and Dismemberment insurance is 30 days of employment.

-**Short Term Disability Insurance** equal to 50% of earnings, first day accident, eight days off, and 26 weeks maximum benefits. Eligibility for Short Term Disability insurance is 30 days of employment.

-**Medical Insurance** through Blue Cross & Blue Shield of Northeast Ohio (the first $75 of the monthly premium for the most comprehensive medical payment plan available). Eligibility for Medical insurance is 30 days of employment.

-**Medical Expense Reimbursement Plan** for reimbursement of medical expenses in excess of reimbursements and payments received from insurance companies, to a maximum of $2,500 per year per employee, no deductibles. Immediate eligibility.

-**Dependent Care Assistance Program** for full-time employees who have completed three months of service and who are full-time. The amount of dependent care expenses incurred to a limitation of $2,500 per employee will be reimbursed.

These formal benefit programs are provided in addition to regular vacations of two or three weeks (depending upon an employee's years of service), holidays, sick leave, other paid time off, and continuing education programs sponsored and paid for by the company. The firm provides some degree of flexibility to employees in planning daily schedules in addition to the above benefit programs.

All benefit programs are available and are used to a varying extent by all full-time employees, and thus it is possible our direct fringe benefit programs could cost between $6,000-$7,000 per employee, exclusive of the cost of governmentally-mandated programs (e.g., Social Security, Workmen's Compensation, Unemployment Taxes, etc.). Furthermore, this cost is spread fairly evenly among employees, notwithstanding compensation levels, due to the favorable eligibility requirements of our benefit programs. Thus, employees across all pay and service levels can and do participate equally in our benefit programs, and clearly employees at the lower compensation levels benefit much more from these programs than employees at higher compensation levels.

Our 14 employees fall into the following compensation categories:

Bracketed Compensation	Number of Employees
Less than $10,000	0
$10,000 - $20,000	6
$20,000 - $30,000	4
$30,000 - $40,000	2
Over $40,000	2

As a small business which sponsors a good variety of formal benefit programs for all employees, we have found such programs to be extremely cost-effective for the employees and the company. For example, our Dependent Care Assistance Program was used by only two employees last year, neither of whom would have been considered a "key" employee under TEFRA; yet, the benefits provided were very much appreciated because of the high expense of providing quality dependent care assistance for children. In fact, the program was specifically put in for three female employees who had childcare expenses. The plan was not used last year by any officer or owner of the company.

We have these benefits for a number of reasons. First, we want our employees to be able to work in an atmosphere conducive to productivity and professionalism, while providing some degree of flexibility. Second, we want employees to know the company cares about them, and this image is conveyed to a great extent through the delivery of non-discriminatory fringe benefits. Third, we want our employees to be long-service employees, and fringe benefit programs attract and retain high-quality personnel who tend to stay. Fourth, the company cares about the financial well-being of its employees and their families, and it wants to do everything possible to maintain the financial integrity of the families of those employees who work for us. Deductible fringe benefit programs greatly aid in this process, because additional spendable income is available to employees to help improve their standards of living and provide more dignity for such people in their day-to-day lives. These programs have been widely used by us over the years, and benefits delivered in the years in which the programs have been operative include death benefits, hospital and medical insurance benefits for all families, dependent care assistance for two families, dental surgery for three employees (none of whom were so-called "key employees"), and finally, and most importantly, an additional layer of financial security for all employees. These programs have literally made the difference in a few situations where the husbands of spouses were temporarily unemployed or laid off--these were the employees who appreciated the dignity that such benefit programs can offer.

Each of the benefits provided by the company is tax deductible to the company and not includible in the income of the employee. We would probably not provide benefits at their current levels if they were taxed to employees, and, since the tendency is for employees not to spend their own funds on benefits, the employees and their families would suffer. The reason we would probably not offer the benefit programs is to escape the legal and accounting expenses associated with the sponsorship of such programs. If current benefits were not deductible **in toto** to the company, the benefit levels would definitely be scaled back to whatever the deductible levels would be.

Although all employees are eligible for all programs virtually immediately, individual program utilization varies from year to year among individual employees based upon the contingencies which arise during a given year. Additionally, the benefit programs are monitored to ensure not only that there is no discrimination among employees, but also to ensure there is no adverse utilization by any employee(s). For example, all employees have been told the sponsorship of such benefit programs is purely voluntary on the part of the company, and if an abuse situation is perceived to be taking place, the benefit programs will be discontinued for everyone. The reason we monitor these benefit programs so closely is that the cash to pay for such programs is very difficult to come by, given the competitive nature of the business in which we operate.

Moving from the narrow view of our own company benefits to a more expanded view of the "whys" and "wherefores" of benefit programs generally, it is clear to me as an employer that the sponsorship of such programs by small and large business promotes and encourages a great degree of individualism among people, boosts morale and promotes an attitude of wanting to make a company "the best in the business". The safety net provided by federal and state programs is commendable, laudable and necessary; however, the support given employees by company-sponsored, voluntary programs can and do lead to a heightened awareness of the positive results tax code provisions for employee fringe benefits can provide, and in the end lead to a greater appreciation on the part of employees of the wisdom of Congress in allowing such programs to proliferate.

Clearly, tax code provisions allowing tax-favored employee benefit programs such as the ones sponsored by our company provide the impetus to offer such programs to all employees. Without such tax code provisions, small business would not offer such benefit programs to employees. In the end, of course, this would mean that employee morale would deteriorate to a certain extent, and the Federal government would probably have to spend more money to provide supporting benefit programs now sponsored by various private companies--not only large companies, but also small businesses such as ours. Based upon the interaction I have with other small business owners, it is fair to say such business owners would love to be in a position to be able to offer every fringe benefit program available to its employees. The reason such employers are interested in providing such benefit programs to employees are reflected in this written testimony.

In summary, it can be seen at least insofar as our business in concerned, that fringe benefits are not installed for the highly paid, but rather they are spread among all job and income classifications; the benefit programs are essential to the economic security of our employees; and there is no doubt our employees will suffer if employer-sponsored benefits do not exist. Since 12 of our 14 employees are female, middle income earners, the burden will fall most heavily on them if such programs are terminated by the company. Thus, we feel the tax law should encourage employers--both large and small--to provide fringe benefits for all full-time employees. The availability of tax free fringes allows a company to provide a more expanded list of benefits to employees, and the end result is that the employees' net spendable income is increased. In our case, this increase in net spendable income to a great extent accounted for anaverage 401(k) deferral percentage of 9.6% of compensation among the lower paid two-thirds employees. Thus, to a very direct extent, the availability of tax free fringes encouraged our employees to save for retirement at a level which is stunning in its long-term impact.

Any conditions or restrictions on minimum age, minimum service, and compensation should be used to encourage rather than discourage the proliferation of fringe benefit programs. Existing rules seem to do a good job of ensuring that all employees benefit equally from the tax incentives afforded by such plans with the exception of private retirement plans. To have these benefit plans available for sponsorship means greater employee morale, flexibility for employees within a changing demographic scenario, greater stability in compensation planning, and stability of employment patterns within industries which wish to provide an array of employee benefit programs. We suggest the Finance Committee consider not only our fact situation, but also other statistical and demographic information supporting the importance of privately sponsored fringe benefit programs, such as the excellent factual data developed by the Employee Benefit Research Institute of Washington, D.C.

In summary, our employees applaud the thought which went into the development of all plans available to them, and they wanted me to extend a special thanks to the Senate Finance Committee for making such programs available. Thank you for the opportunity to provide written testimony, and please let me know if you would like me to provide any additional information.

STATEMENT OF EDWARD N. DELANEY, CHAIRMAN, THE TAX SECTION OF THE AMERICAN BAR ASSOCIATION, WASHINGTON, DC

Senator PACKWOOD. Mr. Delaney.

Mr. DELANEY. Mr. Chairman, Senator Durenberger, Senator Danforth, I am Edward N. Delaney and I appear today as chairman of the tax section of the American Bar Association. I am here today to speak to you about the views of the American Bar Association on certain fringe benefit topics.

I am accompanied by William Sollee, who is the chairman of our Committee on Employee Benefits.

The tax treatment of statutory fringe benefits has become and will continue to be extremely complicated. It will become increasingly difficult for employers and their counsel to sift through, let alone understand, the maze of laws and regulations affecting employee fringe benefits.

While the recent and pending changes may serve legitimate tax policy goals, the resulting complexity threatens to jeopardize the largely self-enforcing aspect of fringe benefit laws.

The American Bar Association recommends that future changes be motivated primarily by efforts to obtain simplicity, and that changes be made only after a comprehensive review and study of the present tax laws governing statutory fringe benefits. We urge that any recommendations for legislation arising out of these hearings take account of these complexities, and that a coordinated legislative effort be developed that will be consistent with simplification objectives.

The ABA strongly believes that the private welfare and pension system should provide equality of treatment for all persons, whether self-employed or employed by others. TEFRA made major strides toward parity by eliminating many of the distinctions between pension plans maintained by incorporated and unincorporated entities. However, important distinctions continue to exist in the pension area, and in the statutory fringe benefits area.

We will emphasize areas of disparity in the statutory fringe benefits context as they exist today, and which we urge this subcommittee to consider amending to achieve parity. These areas are section 79, section 104(a), sections 105 and 106, section 119, section 124, section 125, section 132, section 501(c)(9) and 505.

The parity of treatment that the ABA urges reflects the view that tax provisions governing the private retirement system and statutory fringe benefit plan should not be dependent upon the form of organization of the business. Furthermore, the tax provisions should apply to all employees, regardless of whether a large or small employer is involved.

There is no rational tax policy justifying discrimination based upon business organization or the nature or size of the business conducted. Such discrimination stands in the way of fundamental economic and social policies that are served by the private pension and welfare plans system, and should be ended.

We would also like to support section 120 of the code, which provides for the tax treatment of qualified group legal services plans. It states that an employee's gross income does not include contributions made by an employer to a qualified legal services plan or the

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value of any legal services received by the employee under the plan. This provision expires at the end of 1984 unless extended. The ABA urges that the provisions of section 120 be made permanent. We testified before your subcommittee in March of this year and voiced the ABA's strong support of S. 2080, which would make this important code provision a permanent part of the tax law.

In conclusion, if there is to be a major effort to reform the tax laws and increase Federal revenues, in the next year or two, changes in the law governing statutory fringe benefits should be approached thoughtfully and with due deliberation. The private welfare and pension systems are of critical importance to the country, and the health of the systems need to be preserved. Changes should have simplification as a major goal. Parity for the self-employed, continuation of group legal service plans, improvement of the sanctions system, rationalization of the rules for taxation of distributions, and simplification of the integration rules for defined benefits plans, are all goals to be ardently sought.

Thank you.

Senator PACKWOOD. Thank you. There is one comment I would like to make to you, Mr. Delaney, before we go onto Mr. Mammel. The Treasury Department testified earlier in these hearings that they are not prepared to support the extension of the prepaid legal deduction. Unless there is a change, the same thing is going to happen to you that happened to educational assistance. It's going to expire and it's an uphill battle against the administration and against the House. It can be done, but it cannot be done just by testifying to this committee. That's what we discovered with education. This takes extraordinary lobbying. I think education got blind sided. They didn't expect that such a nice, good, decent employee benefit would be allowed to expire. But it did. The same thing may happen to legal if it is not properly pushed.

Mr. DELANEY. Mr. Chairman, this is not the first time we have had some dispute with Treasury and we do intend to urge the enactment on a permanent basis.

[The prepared written statement of Mr. Delaney follows:]

STATEMENT OF

EDWARD N. DELANEY

CHAIRMAN

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON TAX AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

UNITED STATES SENATE

JULY 26, 1984

My name is Edward N. Delaney of Washington, D.C. I am Chairman of the Section of Taxation of the American Bar Association (hereinafter "ABA"), and I appear before you today to present the views of the ABA with respect to certain fringe benefits topics.

Major revisions in the tax treatment of welfare and pension plans were enacted recently as a part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Deficit Reduction Act of 1984 (DEFRA). Additionally, major revisions in our pension laws are proposed in the pending Retirement Equity Act of 1984. I should also note that it is widely predicted that employee benefit plans will be reviewed as Congress considers revenue measures in 1985.

As a consequence, the tax treatment of statutory fringe benefits has become, and clearly will continue to be, extremely complicated. It is becoming increasingly difficult for employers and their counsel to sift through, let alone understand the maze of laws and regulations affecting employee fringe benefits. While the recent and pending changes may serve legitimate tax policy goals, the resulting complexity threatens to jeopardize the largely self-enforcing aspect of fringe benefit laws.

The American Bar Association recommends that future changes be motivated primarily by efforts to obtain simplicity, and that changes be made only after a comprehensive review and study of the present tax laws governing statutory fringe benefits. The

Section of Taxation would be pleased to be of assistance to the Committee staff in that effort.

DEFRA requires the Secretary of the Treasury to study and report by February 1, 1985, the possible means of providing for minimum standards for employee participation, vesting, accrual and funding under welfare plans for current and retired employees. A report on the health care cost containment aspects of cafeteria plans is also to be made by April 1, 1985. We urge that any recommendations for legislation arising out of these hearings take account of those reports, and that a coordinated legislative effort be developed that will be consistent with a simplification objective.

In addition to these general comments, we have several specific suggestions.

Parity for Self-Employed

The ABA stongly believes that the private welfare and pension system should provide equalilty of treatment for all persons, whether self-employed or employed by others. This position is reflected in a formal policy statement of the ABA which has been in effect since 1963.

TEFRA made major strides toward parity by eliminating many of the distinctions between pension plans maintained by incorporated and unincorporated entities. However, important distinctions continue to exist in the pension area, and in the statutory fringe benefits area.

We will emphasize areas of disparity in the statutory fringe benefits context as they exist today, and which we urge this Subcommittee to consider amending to achieve parity. The areas are:

(1) Group term life insurance (Section 79);

(2) Compensation for injuries or sickness (Section 104(a));

(3) Accident and health plans (Sections 105 and 106);

(4) Meals and lodging (Section 119);

(5) Qualified transportation (Section 124);

(6) Cafeteria plans (Section 125);

(7) Fringe benefits (Section 132); and

(8) Voluntary employees' beneficiary associations (Sections 501(c)(9) and 505).

The parity of treatment that the ABA urges reflects a view that tax provisions governing the private retirement system, and statutory fringe benefits plans, should not be dependent upon the form of organization of the business. Furthermore, the tax provisions should apply to all employees, regardless of whether a large or small employer is involved.

A major objective of legislation with respect to fringe benefits should be to provide incentives for comprehensive inclusion of the broadest possible class of employees in fringe benefits plans. This worthy objective will be furthered by the removal of all remaining povisions in the tax code affecting statutory fringe benefits which result in exluding the self-employed. There is no rational tax policy justifying discrimination based on the form of business organization or the nature or size of the business conducted. Such discrimination stands in the way of fundamental economic and social policies that are served by the private pension and welfare plans system, and should be ended.

Group Legal Services

Section 120 of the Code provides for the tax treatment of qualified group legal services plans. It states that an employee's gross income does not include contributions made by an employer to a qualified legal services plan or the value of any legal services received by the employee under the plan. This provision expires at the end of 1984 unless extended. The ABA urges that the provisions of Section 120 be made permanent. Patrick J. Keating, on behalf of the ABA, testified before your Subcommittee in March of this year and voiced the ABA'a strong support of S. 2080, which would make this important Code provision a permanent part of the tax law.

Alternative Sanctions to Disqualification

Under current law, the sanction for violation of one or more of the requirements for qualification of a pension plan is disqualification of the entire plan. This is true regardless of the significance of the violation. The Section of Taxation believes that this sanction is often unduly severe, and it has under study an alternative sanction system.

The guiding principle is that sanctions should be simple, uniform, and predictable. Further, they should be proportionate to the violation, and should be designed to prevent or to correct the harm caused by the violation. As nearly as possible, the sanction should be easy of enforcement, and without the need for lengthy or complicated administrative procedures. Finally -- and most importantly -- the sanction system should advance policy objectives in this area to encourage private savings for retirement through broad-based employee benefit plans.

For these reasons, the sanction system should seek to put plans where they would have been had they been operated in compliance with the qualificiation provisions of the Code from the start. The sanction should not impose a tax penalty or any other form of "punishment" on the plan or its participants. The sanctions must be sufficiently costly, and their imposition sufficiently certain, to induce compliance, but should be imposed on the person inducing the activity that gives rise to the sanction.

We urge that any effort at tax reform in the private pension and welfare plans area be accompanied by efforts to simplify the system of sanctions for violation of the qualification standards. An excise tax approach to violation of qualification standards, it is submitted, may well offer promise. We intend to continue our work on this matter, and look forward to working with this Subcommittee and the staff in seeking an effective sanction system.

Taxation of Distributions

The statutory provisions dealing with the taxation of distributions from qualified plans, IRAs and deferred annuities are complex and diverse. It is often difficult to determine whether a distribution of an employer's entire account balance from a plan constitutes a lump sum distribution qualifying for the ten-year special averaging rule provided for under Section 402(e). For example, where an employer maintains a PAYSOP and a Section 401(k) thrift plan which allows discretionary investment of account balances and distributions in employer securities, a distribution of an employee's entire account from the PAYSOP in one taxable year on account of his termination of employment may not be a qualifying lump sum distribution if the employee's account balance under the thrift plan is not also paid to him in the same year. This is so since the thrift plan may be considered a stock bonus plan (as well as a profit sharing plan) like the PAYSOP. With the DEFRA provision on rollovers of a partial distribution, it is now easier to determine whether a distribution is eligible for a rollover, but there will still be many types of distributions from qualified plans which do not, but should, qualify for rollover treatment. One of the more difficult questions involves the taxation of periodic payments from a thrift plan to which employee contributions have been made. It is often impossible to determine whether to treat all payments as first being a return of employee contributions or to utilize an exlusion ratio for each payment which attributes part of each payment to employee contributions (which are not taxed) and part to employer contributions and earnings (which are taxed).

If employees are not able to determine the character of distributions, widespread noncompliance will occur. This type of noncompliance is by and large inadvertent, and much of it can be avoided if the rules governing the taxation of distributions are made more uniform and simple.

The Section of Taxation has recently undertaken a project to consider ways in which this uniformity and simplification can be achieved. We will be pleased to share the results of our study with the Committee, and we urge that future tax reform include consideration of these matters.

Qualified Retirement Plans Integrated With Social Security

Qualified pension plans may not discriminate in favor of officers, shareholders and highly compensated employees, but they may be integrated with Social Security.

TEFRA tightened the integration rules applicable to defined contribution plans, but did not deal with those for defined benefit plans. Under the latter rules integrated plans may be categorized as either "excess" plans for "offset" plans. Under an excess plan, benefits may be provided exclusively for those participants whose earnings exceed social security covered compensation. Under an offset plan, benefits may be offset by 83-1/2 percent of the primary social security insurance amount. Under both types, lower-paid employees may be essentially excluded from benefit entitlement.

We believe that the integration rules applicable to defined benefit plans are overly complex and in some cases inequitable. The Section of Taxation has undertaken a study to determine whether simpler, more equitable rules are possible. We will be pleased to share the results of our work with the Committee and its staff. We submit these matters should be taken account of in the attempt to reform and simplify our private retirement system.

Conclusion

If there is to be a major effort to reform the tax laws, and increase federal revenues, in the next year or two, changes in the law governing statutory fringe benefits should be approached thoughtfully, and with due deliberation. The private welfare and pension systems are of critical importance to the country, and the health of the systems needs to be preserved. Changes should have simplification as a major goal. Parity for the self-employed, continuation of group legal service plans, improvement of the sanctions system, rationalization of the rules for taxation of distributions, and simplification of the integration rules for defined benefit plans, are all goals to be ardently sought.

STATEMENT OF CARL G. MAMMEL, PRESIDENT, THE ASSOCIATION OF ADVANCED LIFE UNDERWRITING, WASHINGTON, DC

Senator PACKWOOD. Mr. Mammel.

Mr. MAMMEL. Thank you, Senator Packwood. First, I would like to express our appreciation for the opportunity to testify at the hearing, and to thank you for your interest and the interest of your committee in the subject of employee benefits.

I am here as the president of the Association for Advanced Life Underwriting, which is an organization of 1,100 members, principally including firms like ours. We are involved in the employee benefits business similar to Mr. Facciani, and employ 65 or 70 people working principally with small businesses in helping them with their employee benefit problems. Another similar member of ours that you are familiar with, Senator Packwood, is Eli Morgan with the MCG Northwest firm. Eli is one of AALU's members.

So I am here speaking for the members of AALU and perhaps even more important for the small businesses that our members serve. And I am here to speak to you as a small business owner and some of the concerns that I have.

Certainly it is not necessary with this group to discuss the importance of keeping the employee benefits business in the private sector. That seems to be what everybody before me has said. And we would certainly support this and feel that most small businesses share that view. We believe that a private system of providing employee benefits is more efficient than the Government doing it with the administrative load that would be required. And, more important, if the Government provides employee benefits, they would provide them for everybody, irrespective of need, and I think it's apparent to all of us that the cafeteria flexible benefits compensation concept, as pointed out—that there are differences in need and that we should solve the needs of individuals and not of everybody which may not be the same.

The Government tax incentives have promoted employee benefits. Certainly, if we were to look back 30 or 40 years ago and predict how many firms would have health insurance plans, dental insurance plans, group life insurance plans, disability plans, retirement plans, we would have predicted a much lower percentage than has actually occurred.

There is, however, an area of void. Not necessarily a void, but small business has fallen behind; particularly, in the area of retirement plans. It's important to keep in mind that small business represents a large portion of the population of the United States. Fifty-three percent of businesses have four or fewer employees. Seventy-two percent have less than 10 employees. Some 14 million employers, principally small employers, small businesses, provide 60 percent of the jobs. Well, our employee benefit system today has presented small business owners with some serious problems.

And what I would like to do is to just touch on these four problems that I think need to be addressed by your committee in planning for the future.

We now have in our tax laws a small business exclusion test where topheavy provisions have been applied not only to qualified plans, but to legal services, child care, educational benefit plans, and cafeteria plans. This was not plans that are discriminatory, but just simply plans where a certain percentage of the benefits go to owners.

Mr. Delaney talked about the lack of parity that exists between partnerships, if you will, and corporations. And I won't add any more to that, but that certainly is affecting small business.

We have had serious problems with the complexity and the frequency of the change of the laws, and this is very important to small business because to revise a qualified plan for an employer of 10,000 costs the same as revising a qualified plan for an employer of 50 or 25 employes. And the small employer just won't do it.

The other thing that is happening is that we have IRS manipulation of the laws either through the issuance of regulations or the lack of issuance of regulations. I hope that you will keep these comments in mind in your planning as they may affect small business.

Thank you.

[The prepared written statement of Mr. Mammel follows:]

STATEMENT OF
CARL G. MAMMEL, CLU, PRESIDENT
ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

Presented on Behalf of the
Association for Advanced Life Underwriting
Before the Subcommittee on Taxation
and Debt Management of the
United States Senate Committee on Finance

July [illegible]0, 1984

My name is Carl Mammel. I am an independent life insurance agent from Omaha, Nebraska, and appear before you as president of the Association for Advanced Life Underwriting (AALU). I am accompanied by Gerald Sherman and Stuart Lewis of the Washington, D.C. law firm of Silverstein and Mullens who are counsel to AALU.

AALU is a nationwide organization of approximately 1,100 members specializing in one or more fields of advanced life underwriting. Collectively our members are responsible for annual sales of life insurance in excess of $2 billion, mostly in circumstances involving complex factual situations and often dealing with qualified retirement plans and other employee compensation techniques. Much of the work performed by our members is with small businesses. Consequently, AALU is in a position to speak with authority concerning the problems of the small business community with respect to fringe benefits and the private pension system.

The National Association of Life Underwriters (NALU) is independently submitting its own testimony which AALU has reviewed and fully endorses.

I. Introduction

A. Importance of Small Business

Because much of AALU's work is with small businesses and because AALU is particularly knowledgeable concerning the use of fringe benefits by small businesses, our testimony will focus primarily on the availability and use of fringe benefits by that vital segment of the economy. It should be noted at the outset that historically America has always been a community of small businessmen.

Even today small business accounts for between 39 and 50 percent of our gross national product. Over 14 million small businesses employ 60 percent of the entire national workforce and create more new jobs by far than any other sector of the economy. Of 16 million jobs added to the economy over a 10-year period, 12 million were created by small business.[1/]

B. Need to Address Small Business Concerns

There is an urgent need for the direction of Congressional attention to a number of major problems concerning the provision of fringe benefits by small

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1/ These statistics are primarily derived from the Small Business Administration. See SBA, Facts About Small Business and the U.S. Small Business Administration (February 1981).

business. A recent study has demonstrated that pension and health care coverage is less extensive for workers in small business than for workers in large business. Only 30.9 percent of employees in small firms with fewer than 10 employees have both health and pension coverage, whereas for large employers, 95.3 percent of workers have both types of coverage. This study has indicated that, among the principal reasons for the lower pension coverage, are the high cost of setting up the plan, plan complexity, the need for costly expert advice and the constantly changing governmental regulations that create uncertainty about future costs and benefits.2/ The implicit conclusion of this study (a conclusion to which Congress has frequently failed to give legislative credence) is that small businesses are less able to cope with complex standards and administrative costs than are large businesses. The inherently costly nature of changing

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2/ See Coverage, Characteristics, Administration, and Costs of Pension and Health Care Benefits in Small Businesses, Final Report, submitted to the Office of Advocary, Small Business Administration, James Bell and Associates, Inc. and ICF Incorporated (March 1984).

legislative rules imposes on small business a burden that may be intolerably high when compared to the employee benefits that are thereby generated. If, for example, a large plan spends $10,000 on expert advice to gain understanding of complex new rules, that $10,000 is a relatively low cost per employee. For a company with 10 employees, however, the cost per employee is much more substantial and often prohibitive. When one considers the added fact that the cost may be a repetitive annual one because of the frequency of new laws and regulations, the problems become even more intractable.

The importance of small business in the American economy and in the American workforce mandates that Congress change its focus regarding the development of laws and regulations on fringe benefits. The focus should be centered on the problems and concerns of small business. As we note in greater detail in this testimony, many of the newer Congressional approaches to fringe benefits often operate to discriminate against small business by denying such businesses the availability of such benefits on a reasonable parity with larger businesses. Thus, a substantial portion of the American workforce is being denied equal access to tax-advantaged employment benefits.

C. Importance of Fringe Benefit Tax Incentives

Tax-advantaged fringe benefits are undeniably of major importance in accomplishing worthwhile social goals. It has clearly been demonstrated that tax incentives will cause employers to alter their economic behavior.3/ Special tax incentives, such as the availability of tax-free educational expenses or day care, have played a major role in stimulating employers to adopt such programs. Tax incentives for qualified retirement plans constitute a classic example of this behavioral change phenomenon, with between 50 percent and 80 percent of the workforce now receiving pension

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3/ See Feldstein and Clotfelter, "Tax Incentives and Charitable Contributions in the United States: A Microeconomic Analysis," published in III Commission on Private Philanthropy and Public Needs 1393 (Dept. Treas. 1977).

coverage.[4/] Without tax based motivation, the life, health and retirement coverage of our workforce would be substantially diminished and the workers in this country would be far less secure than they are today.

Recent actions by Congress have indicated that, through pension and fringe benefit statutory amendments that are designed to capture relatively insignificant amounts of revenue, short-term budget considerations are undermining the long-term security of workers' benefits. It is important that, before there is a change in any major aspect of the employee benefit system, there should be placed on the proponents of the change a heavy burden to demonstrate need for its implementation. The laws underpinning this system reflect inherently long-term planning goals for employers and employees that will be adversely affected if changed frequently.

With these general principles in mind, we will approach specific areas of concern.

4/ See, e.g., Munnell, The Economics of Private Pensions (Brookings 1982).

II. AREAS REQUIRING CONGRESSIONAL CONSIDERATION

A. Trend Toward Discriminatory Treatment of Small Business Employees.

1. Description of Trend.

AALU is alarmed at an unfortunate trend in legislation involving a departure from the historic discrimination standards used in the employee fringe benefits area. The trend, which is both recent and appears to be gaining momentum, involves the effective denial to the small business management level of various tax-advantaged fringe benefits that are otherwise available to their counterparts with large corporations. Recent changes to the Internal Revenue Code have denied benefits to the executives of small firms where more than a certain percentage of the total benefits are made available to them, whether or not there has been a pro rata allocation of benefits to rank and file employees or, in fact, whether or not there are rank and file employees to whom an allocation can be made. Essentially, Congress has imposed a new layer of restrictions (effectively applicable only to small business) that function in addition to the traditional nondiscrimination rules for qualified plans and selective statutory fringe benefits.

This layer of restrictions creates a situation in which executives of large corporations and of small businesses that earn the same rate of pay are not treated equivalently for fringe benefit purposes. Such discrimination is not desirable from either an economic or social point of view and is contrary to articulated public policy favoring the initiation and development of small business. If the trend is permitted to grow, the cost of operating a small business will increase while, at the same time, small business recruitment of first class talent will be severely impeded.

The trend to which I refer is best exemplified by the qualified group legal services plan provisions added to the Internal Revenue Code (hereinafter, Code) by the Tax Reform Act of 1976, child care plan provisions added to the Code by the Economic Recovery Tax Act of 1981 (ERTA), the pension top-heavy rules added by the Tax Equity and Fiscal

Responsibility Act of 1982 (TEFRA), and most recently, the cafeteria plan rules in the Tax Reform Act of 1984. The education assistance plan provisions of section 127, which expired at the end of last year, also exemplify the trend. I will explain these provisions and their impacts.

a. Qualified Group Legal Services Plan.

With the enactment of the Tax Reform Act of 1976, Congress adopted for the first time in the history of the Internal Revenue Code, restrictions on a fringe benefit that denied plan benefits to owners if they received more than a certain percentage of benefits.[5/]

5/ Although the H.R. 10 plan rules contain limitations that appear similar, they did not evolve out of an effort to limit benefits to smaller employers, but rather, they evolved from a Congressional reticence (now generally accepted to be misplaced) to extend corporate tax benefits to the self-employed segment of the economy. See II, C, infra.

Under Code §120, an employer is permitted to establish a prepaid, nontaxable personal legal services plan for its employees if certain qualification requirements are met. The provision contains standard nondiscrimination requirements with regard to eligibility and coverage, benefits and the operation of the plan. In addition, it contains a requirement that no more than 25 percent of the amount contributed during the plan year be used for the benefit of 5-percent owners. In effect, if more than 25 percent of the benefits go to this group, no one in the group may exclude the benefits received. For many small firms, this is a virtual impossibility due to the ratio of owners to common-law employees. On the other hand, a large corporation with such a plan and with hundreds of employees can easily meet the restrictions, thereby permitting corporate executives to participate and receive benefits that their small business counterparts are effectively denied.

b. Educational Benefit Plans.

Until December 31, 1983, when Code section 127 expired, amounts paid for expenses incurred by an employer for educational assistance provided to an employee were excluded from the employee's gross income if paid or incurred pursuant to a written plan that met certain requirements and that was for the exclusive benefit of the employees. Excludable amounts included tuition, fees, and similar expenses, as well as the cost of books, supplies, and equipment paid for or provided by the employer. The provision contained certain standard nondiscrimination requirements with regard to eligibility and coverage, benefits, and the operation of the plan. In addition, section 127, which was effective for taxable years beginning after December 31, 1978, contained a requirement denying the exclusion where more than 5 percent of the benefits were paid to 5-percent owners of the business. Under these constraints, in order for a small employer to receive the advantages of an educational benefit plan, ninety-five percent of the benefits had to go to nonowners.

c. Child Care Plans.

Under section 129 of the Code, enacted in 1981, an employee who receives dependent care assistance payments provided under an employer's written plan may exclude the payments from his or her gross income subject to an earned income limitation. The provision contains nondiscrimination requirements conforming to the traditional nondiscrimination rules, however, the section also contains a requirement similar to that for qualified group legal services plans that not more than 25 percent of the amounts paid or incurred by the employer during the year be provided to individuals who are 5-percent owners. In effect, if more than 25 percent of the benefits go to this group, no one in the group may exclude the benefits received. Thus, once again, because it is far more difficult for a small firm to conform to this top-heavy limitation than a large one, small entrepreneurs may be effectively denied the benefit.

d. Pension Plan Top-Heavy Provisions.

In 1982, TEFRA added to the Code §416 which contained a new set of broad scale qualified plan requirements which effectively limit benefits for key employees of top-heavy plans.

Essentially, under these rules, in order to remain qualified, plans that are top-heavy must meet more rapid vesting schedules, provide a minimum benefit or a minimum contribution for all non-key employees, restrict the amount of compensation that may be taken into account by the plan in determining contributions or benefits and reduce the overall limits on contributions of benefits under an employer's defined contribution and defined benefit plan. The rules automatically apply where 60 percent or more of the benefits provided under the plan go to key employees who are defined as certain owners, officers and the highly paid. Since a disproportionately large share of top-heavy plans are small plans consisting of an owner and several common law employees, the rule leaves a small employer with a series of unpalatable choices. He may cut back his own benefits so that they are proportionately lower than the benefits of his employees, or he may bear the cost of providing proportionately larger benefits to his employees. If, as if often the case, neither choice is acceptable, the employer will have no viable alternative but to terminate the plan and cut off benefits to all employees.

e. Cafeteria Plans.

On July 18, the President signed into law the Tax Reform Act of 1984 which contains new fringe benefit rules affecting cafeteria plans. Under these rules, not more than 25 percent of the total nontaxable benefits of the plan can be provided to employees who are key employees as defined in the section 416 top-heavy rules. If the 25 percent limitation is exceeded, key employees will be taxed as though they receive taxable benefits to the extent possible under the plan. Thus, under these new rules, many small business executives may not be able to participate in a cafeteria plan because there would be no way to avoid the 25 percent limitation. For example, in the situation where a plan consists of a key employee and two common law employees, and the benefits are distributed on an equal basis, the key employee will receive benefits that are in excess of the statutory 25 percent limit.

2. Inequitable Application.

The limiting provisions in all of these arrangements essentially reach only executives of small businesses. Whenever these executives receive more than a certain specified percentage of benefits under their plans, they are precluded from obtaining for themselves any of the tax-advantaged benefits of the established programs. This is the result whether or not there are other employees to be considered, or where, if judged under the traditional nondiscrimination rules, the benefit arrangement would be considered to have provided a fair percentage of benefits to common-law employees.

The special limiting provisions of Code §§120(c), 125(b), 129 and 416 should be viewed in contrast to the traditional nondiscrimination rules that apply uniformly regardless of the size of the business involved. For example, in order to satisfy the requirements of the traditional nondiscrimination standards of Code §§401 (qualified retirement plans), 79 (group term life insurance) and 105 (medical costs), contributions and benefits must be equally allocated on the basis of compensation to all employees in the covered group. As a general rule, provided every covered employee receives a percentage of benefits equivalent to his percentage share of total compensation, there is no discrimination. The special limiting rules in Code §§120(c), 125(b), 129 and 416 apply over and above these traditional nondiscrimination rules and create more stringent requirements that effectively deny benefits to executives of small firms.

AALU seeks uniform treatment for all employees across-the-board regardless of the size of the organization for which they work. If in a given set of circumstances, Congress feels it necessary to limit the economic group to which tax benefits are granted, there is ample precedent for doing it in an equitable fashion which does not discriminate against small business. Code §415, for example, limits contributions to qualified plans by reference to a certain level of compensation that applies to all participants based on a flat percentage of salary or a set dollar limit regardless of the size of the business involved. One might take issue with the social policy on which section 415 is based, however, once that policy is accepted, section 415 goes on to generate a tax neutral rule as between large and small businesses. In a like way, our social security laws contain an across-the-board limit on the amount of compensation that will be considered for those purposes.

3. Need for Neutrality.

The tax laws should be tax-neutral respecting incentives for employment with large versus small business. To favor large business in the manner that has recently occurred severely hampers the ability of small business to develop and grow. Small businesses are typically service-oriented and are designed around the creative skills of a single individual or a small group of individuals. If the tax laws favor employment with large firms over small firms, talent will be drained away from existing small businesses and creative individuals will be discouraged from taking entrepreneurial steps to establish small businesses. Further, the lack of ability to retain qualified executives will encourage small businesses to be acquired by and merged with large businesses, thereby further diminishing the pool of small business talent in this country.

Real tax-neutrality would lead to special incentives for small businesses. Small businesses are at an automatic disadvantage compared to large businesses because of administrative costs, limitation of cash resources and other inherent problems. For example, it should be remembered that large corporations have opportunities, not available to small firms, to dispense to their employees tax-advantaged equity benefits such as stock-options. Real equality necessitates special incentives to offset these inherent disadvantages. Tax credits (limited to small businesses) for the set-up costs of fringe benefits programs for employees, for example, would reduce the initial costs that are particularly burdensome for small businesses.

AALU strongly urges Congress to recognize that there is a growing trend involving the denial of benefits to small business management level executives. The trend is both arbitrary and unfair and we recommend that Congress correct the course by imposing only those limits that are applied uniformly to all employees whether they work for a small firm or for the largest corporation.

B. Unnecessarily Large Administrative Burden on Small Business.

Major pension legislation has, in recent years, unfortunately, become too frequent, including, for example, the Tax Reform Act of 1984, the Tax Equity and Fiscal Responsibility Act of 1982, the Economic Recovery Tax Act of 1981, the Multiemployer Pension Plan Amendments Act of 1980, the Revenue Act of 1978, and the Tax Reform Act of 1976. Following each of these legislative enactments, the Internal Revenue Service (Revenue Service) develops, over an extended period of time, temporary, proposed and final regulations that contained additional changes not clearly envisioned as part of the statutory structure. Further, the Revenue Service, in its administration of these laws, changes its interpretation through Revenue Rulings and other announcements that require further plan changes.

Plans are expected to be continually updated and submitted to the Revenue Service for approval of their qualified status under the tax laws. This has become a most difficult burden for employers and plan administrators. Yearly keeping up to date with regulatory changes is a substantial burden, but the added impact of the frequent legislative changes, especially the major changes included in this years Tax Act and TEFRA, have seriously exacerbated this problem. Coupled with this is the fact that most of the substantive employee benefit changes made by the Tax Reform Act of 1984 and TEFRA impact primarily on small business, a group that is less capable of accommodating these changes than are other segments of the business community.

The result is the creation of appreciable administrative burdens and an increase in operating cost for pension and profit sharing plans, especially those of small business. These cost increases arise not only from the substantive impact of the changes in the rules, but also from the administrative necessity of keeping the plans abreast of applicable legal requirements. Especially in the case of small plans, this burden may be very substantial indeed.

By and large, big businesses are better equipped to handle the complexity of the new laws than are small businesses. Large firms typically have their own specialized in-house staff familiar with employee benefits and have the resources to hire outside counsel for any additional expertise, as needed. Small firms, on the other hand, infrequently retain in-house benefits experts and, due to their size, typically use outside consulting, accountant, actuarial, and legal firms for advice, which may cost more than retaining in-house expertise.

According to a recent study prepared for the Small Business Administration by James Bell and Associates, Inc. and ICF, Incorporated, per capita pension costs are substantially nigher for small firms than for large. This study indicates that per capita costs declined from approximately $1,080 for firms with one to ten workers to $574 for establishments with 500 to 999 workers. Further the study shows that per capita pension administration costs, which are highest for very small firms (one to ten employees), decrease as firm size increases.[6/]

6/ Coverage, Characteristics, Administration, and Costs of Pension and Health Care Benefits in Small Business, Final Report, submitted to the Office of Advocacy, Small Business Administration, by James Bell and Associates, Inc. and ICF Incorporated (March 1984).

The study also showed that about half of the small firms studied administer their plans themselves and about one-third use outside plan administrators and the remainder rely on insurance companies.7/ The study also documents that the ongoing administrative costs for small firms (under 100 employees) are an estimated $500 to $1500 per year (depending on the type of a plan and the number of participants).8/ With regard to the source of these costs, many small employers included in the study observed that it was not so much the regulations that were a burden, but rather the constant changes in laws and regulations which often impose substantial costs on the firms when they made plan amendments.9/ Among those areas of regulation and reporting requirements that were considered most burdensome by small employers were parts of the Form 5500, "Controlled Group Requirements", Percentage Coverage Requirements, some

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7/ Id. page 75.

8/ Id. page 75.

9/ Id. page 76.

regulations under the Multiemployer Pension Plan Amendment Act, and "Merger and Spin-Off Rules".10/

C. <u>The Need for Full Parity Between Corporate Employers and the Self-Employed.</u>

One of the major beneficial aspects of TEFRA was a move to establish partial parity between corporate and noncorporate employers. Particularly in the treatment of qualified retirement plans, TEFRA largely eliminated the distinction that had existed between the two types of employers--a distinction which at this point is almost entirely one of form rather than of substance. To perpetuate it through the income tax laws does not serve to further any valid purpose. Instead, such a distinction merely adds unnecessary complication to the laws and encourages incorporation of businesses that would otherwise continue to operate in noncorporate form. The net result has been a proliferation of corporate entities motivated by the desire to utilize tax benefits available only to corporations when there

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10/ Id. page 76.

is, in fact, no valid policy reason to treat corporate and noncorporate employers differently.

Because TEFRA has taken substantial steps towards full parity, Congress should now take the final step and complete the process. Congress should eliminate the other distinctions that exist in the law between corporate and noncorporate fringe benefits. Two of the most important of these are the treatment of group-term life insurance and the treatment of medical benefits for employees. Under the statutory rules of §§79 and 105, respectively, these benefits are only available through corporate form even though on policy grounds, self-employed individuals, as well as corporate employees, are equally entitled to the benefit of these rules.

Section 79 permits the exclusion of up to $50,000 of group-term life insurance purchased for an employee by a corporate employer. Where a self-employed individual purchases life insurance for himself, he does so with after-tax income and receives no deduction.

Section 105 generally provides that amounts received by an employee as reimbursements for medical care and payments for permanent injury or loss of bodily function are excludable from gross income. Under §105(g), a self-employed individual is not treated as an employee for purposes of §105. Therefore, for example, benefits paid under an employer's accident or health plan under §105 to or on behalf of a self-employed individual will not be treated as received through accident and health insurance for purposes of the exclusions found in §105.

Similarly, section 404(a)(8) limits the amount of contributions to qualified plans on behalf of self-employed individuals in a way that contributions on behalf of corporate employees are not limited. Section 404(a)(8)(C) permits a deduction for contributions only to the extent that such contributions do not exceed the earned income of the individual and to the extent that the contributions are not allocable to the purchase of life, accident, health, or other insurance. This provision tends, without a rational basis, to hamper the purchase of life, accident, health or other insurance through a qualified plan for self-employed individuals. Such a limitation does not apply to corporate employees.

We recommend that Congress promptly enact legislation eliminating all further distinctions in the tax laws in the employee benefit area between corporate and noncorporate business entities so that any benefits that are available for corporate employees should be equally available for self-employed individuals.

D. Manipulation of System by Agencies Charged with Administering the Tax Laws.

Congress frequently leaves to the Revenue Service responsibility for carrying out the laws through the promulgation of regulations. In some instances, the Revenue Service and the Treasury Department have used the issuance (or nonissuance) of regulations as a way to promote their own policy objectives whether or not those objectives reflect Congressionally propounded policy. A notable and recent example involves the 6-year delay in the issuance of the proposed cafeteria plan regulations under §125. In the six years since the enactment of the section in 1978, numerous corporations had adopted cafeteria plans based on a reasonable interpretation of the statute and its legislative history. When the Revenue Service finally issued a news release and proposed regulations earlier this year, it took a very restrictive approach to what would be permissible under §125. To add insult to injury, the Revenue Service also proposed to apply these regulations retroactively even though it was well aware that the practices it proposed to prohibit had been employed in a large number of cases. The employment of those practices were not only arguably permitted under the statute, but were in fact encouraged by the government's failure to issue regulations during the six year period. In effect, the lack of action by the Treasury and the Revenue Service had the effect of enticing taxpayers into activity which those same agencies subsequently and retroactively said was impermissible.

AALU respectfully submits to this Committee that an agency should not be permitted to use the issuance or nonissuance of regulations as a way to promote policies that have not been enacted by Congress. Congress can avoid this problem in the future, by requiring the issuance of regulations within a reasonably short period of time after enactment of any new provisions affecting employee benefits. Failure to issue those regulations within the allotted time should preclude the issuing government agency from applying them with retroactive effect.

E. Section 79 Nondiscriminatory Life Insurance Exemption Should be Raised to $100,000.

Section 79 provides that the cost of up to $50,000 of group-term life insurance paid by an employer shall be excluded from the income of the employee. Section 79 was enacted in 1964 and the $50,000 limit has not been changed since that date. AALU respectfully submits that the amount should be adjusted to reflect increases in the cost of living.

The legislative history of §79 reveals that in setting the $50,000 limit, Congress considered whether the dollar amount was adequate to keep a family unit together when a breadwinner dies prematurely.[11/] The House of Representatives had initially set the limit at $30,000 but the Senate, indicating its concurrence with the policy to protect family units, adopted a higher limit, $70,000. (In conference, the conferees settled on $50,000 without further explanation.)

In 1964, the dollar had the purchasing power of $1.08 (compared to the value of the dollar in 1967). In May, 1983, that same dollar had a purchasing power of only 34¢.[12/] In other words, in the nineteen years from the enactment of section 79, the purchasing power of a dollar has dropped by more than two-thirds and the value of the $50,000 limit today is the equivalent of only $15,741. In order to restore the limit to its original purchasing power and to carry out the Congressional intent to

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11/ Revenue Act of 1964, House Report No. 749, 88th Cong., 2d Sess. 39-40 and S. Rep. No. 830, 88th Cong., 2d Sess. 45-46.

12/ Statistical Abstract of the United States 1984, U.S. Department of Commerce, Bureau of the Census, p. 484.

permit the exclusion of an amount paid to purchase a sufficient amount of insurance to keep the family together at the time it looses its breadwinner, the $50,000 limit would have to be increased to $158,821.

The $50,000 limit in §79 is grossly out of date because it has never been changed to reflect current economic realities. AALU is not suggesting that Congress apply automatic cost of living increases over which Congress has no control once enacted. Rather, AALU recommends that Congress increase the limit by setting an amount, perhaps $100,000, that takes into consideration the loss in the dollar's purchasing power since 1964. AALU suggests that the new limit be at least $100,000.

AALU stands ready to assist the Committee in this important fringe benefit review. We appreciate the opportunity of presenting our views to you.

Thank you.

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Senator PACKWOOD. One thing that I have discovered in my years serving in Congress is that business would almost rather put up with unfairness than uncertainty. If you were to write a tax system that was bad, but you were to say you can have this for 10 years and you can count on it, and it won't be changed, business is amazingly versatile and flexible and somehow they would bring themselves to live with it. But we do change it, and there is a tax reform bill every year. Russell Long was right when he said we should pass a law that prohibits the use of the word "reform" in a tax bill.

Mr. MAMMEL. I'm reminded of Mr. Facciani's comment about the fact that his firm has installed a plan of cafeteria benefits. We did the same thing, and the day after we announced it came the proposed regulations which completely unwound what we had announced.

Senator PACKWOOD. You are absolutely right.

Mr. MAMMEL. The Government had 6 years to issue those regulations.

Senator PACKWOOD. You know why they issued them. They were trying to force our hand, and they got basically what they wanted. They got a severe limitation of employee benefits; we codified some that we hadn't codified before that they were never going to be able to tax anyway. But I understand exactly why they did it and when they did it and it wasn't that it took them 6 years to do it. My hunch is when they finally decided to issue the regulations it didn't take them more than 2 weeks or 4 weeks to actually draw them up and issue them.

Dave?

Senator DURENBERGER. I have no questions, Mr. Chairman. I do find the statements, the oral statements, to be very helpful.

Senator PACKWOOD. Gentlemen, thank you very much.

Wait. I didn't see Senator Danforth come in. I apologize.

Senator DANFORTH. Gentlemen, can you explain to me just as a matter of public policy why Congress should prefer one form of compensation over another form of compensation? That is, the concept of tax-free fringe benefits is that we have reached a conclusion as a matter of Government policy that we want business to be paying their employees in the form of fringe benefits as opposed to cash compensation. And we will reward the fringe benefit decision by not taxing it. If the business makes the mistake of paying cash, particularly too much cash, we will really sock it to them. And maybe there is a policy reason why we should tax one form of compensation over another. I have been fishing for it a number of years now. And maybe you can help me figure it out.

Mr. JACKSON. Senator, I think when our country started out taxing income it was taxing cash income. This was an easy thing for an individual to deal with. As our society has evolved, we come out with many, many more concepts of what constitutes income. You say fringe benefits constitute income. The benefits are paid to certain people, and in some cases taxed once. And then you try to tax them again because the employee is covered. Group life insurance is an example. Survivor income coverage is an example. If someone dies, a benefit is paid to the survivor and the survivor pays an income tax on it. Why should we go around and also tax the employees who didn't die on imputed income?

We have the Treasury now talking about taxing the imputed rental value of an owner occupied home. Most people think this is ludicrous. The Treasury doesn't. I suppose the rental value of an owner used set of golf clubs or an owner worn tuxedo—anything other than pure consumption, you can say is income and we should be taxing someone for it.

Senator DANFORTH. But we are not talking about the use of somebody's golf clubs. We are talking about big, big dollars, aren't we?

Mr. JACKSON. Well, in the case of medical coverage, for example, the tax treatment came about because as a society we didn't want to tax sick people. We are providing the coverage to all sorts of people. Someone who is healthy and reaches the end of a year without having had to use any of these services at all, has been given coverage that is worthless. Demonstrably, it shouldn't be taxed. The benefits are paid to people who are sick and the question is do you want to tax them. Maybe you do want to tax the rich ones. Maybe there should be an income tax of some sort. But we require now a 5-percent of pay throwaway on medical expense deductions, and maybe that's too high. Maybe we should tax all the benefits and lower the deduction and be done with it. That way the people in high tax brackets would get a better break than the people in low tax brackets. And the tax expenditure would be eliminated.

But, basically, as you sit down and try to focus in on how you are going to tax these things—the process is almost self-defeating. Congress has been rumored to be thinking of taxing pension funds, for example, or employee thrift and savings funds in order to cure the deficit and take some of the pressure off of interest rates. As you know, there are only so many funds around, and a bunch of borrowers come in and then the Government comes in with its debt and the borrowing pressure raises the rate of interest. When you take $10 billion from pension funds and transfer it to the Federal Government, and lower the debt by $10 billion, you have also lowered the supply of funds available for investment by $10 billion and you are chasing your tail. Nothing has been accomplished.

You have to be very careful, but I would like to second what these gentlemen have said about the simplicity. The code itself now is terribly complicated.

Senator DANFORTH. Well, the way it gets complex is that we just keep piling up exceptions. We have a basic tax that is applied to taxable income, and then we start developing all of these exceptions. So we have to have relatively high rates in order to pay for all the exceptions. All these fringe benefits programs are the same as entitlement programs. You are just saying to the business or to the taxpayer, well, if you want to fall within such and such a category, have at it, and Uncle Sam will take the money out of somebody else's pocket.

And I don't understand the policy justifications. For us to mean that as a matter of public policy that we in the Government prefer, we in the Congress prefer, you in business to pay people compensation in one form rather than another form.

Mr. MAMMEL. Senator, at least from my perspective it seems that it's appropriate from the standpoint of providing financial security for death, disability, catastrophic medical expenses, and retirement be the principal areas. And it is an incentive for individuals to take care of themselves and for businesses to help these individuals take care of themselves as opposed to not doing this in advance and letting it fall to the Government.

Senator DANFORTH. Well, that doesn't apply to legal services or the van commuting the services, child care assistance, employee discounts, tuition.

Mr. MAMMEL. I'm not suggesting that that point applies to everything, but it does apply to some major areas, and I think that should be kept in mind.

Senator DANFORTH. Do you like cafeteria plans? Do you think they are a good idea?

Mr. MAMMEL. Yes; I do.

Senator DANFORTH. Just write your own tax bill.

Mr. MAMMEL. No, not writing my own tax bill. I think it's a matter of risk shifting. We use the cafeteria plan in our company in order to implement a medical plan with a very large deductible, $300 or $400, in order that people would be mindful of the medical expenses and wouldn't nickel and dime the plan to death, if you will. And if they don't incur these medical expenses, then that compensation will be provided to them either through some other form of benefit or we would hope to pay it to them in cash. We felt that was something that was going to control health care costs in the long run and cut our costs down.

Senator DANFORTH. Anybody else have a comment that you would like to make on this?

Mr. DELANEY. Senator, on behalf of the ABA we are limited in what we can say by what positions have been adopted by the ABA. We don't feel it would be——

Senator DANFORTH. The basic thrust of your testimony was your concern about the complexity of the code.

Mr. DELANEY. That's correct.

Senator DANFORTH. And it sure is getting more and more complex. I mean to the extent—people now—I was just back in my State. Everybody was asking, well, what do you think about a flat tax. When I explained that we just passed a 1,300 page tax bill, they said what do you think about the flat tax. And I take it that the advocates of all these fringe benefits don't think much of a flat tax because I mean the whole theory of all of these fringe benefits is the more complex we get the code, the better. We tax different forms of compensation different ways. And if you can think up fringe benefits and develop plans that are attractive, have at it.

Do any of you support the flat tax?

Mr. JACKSON. It's——

Senator DANFORTH. Thank you, Mr. Chairman.

Mr. JACKSON. It's simple, Senator.

Mr. MAMMEL. I think if we had a full understanding of what the flat tax would be and how it would work we could respond to that question. I'm not sure I understand what it all means. I wouldn't say I'm categorically opposed to a flat tax.

Senator CHAFEE. Let me just ask one question if I might, Mr. Chairman, of Mr. Jackson. What happens to the fellow who isn't fortunate enough to work for a company that provides your splendid benefits, and yet he has to purchase these himself? Is that just too bad? Would he have to buy these things at after tax dollars? Is that just too bad for him? He just wasn't lucky enough to get with the right company.

Mr. JACKSON. I think it's too bad at the present time. I think one of the problems is the way we tax savings in America. That individual has the wonderful option of putting money off——

Senator CHAFEE. How——

Mr. JACKSON. That individual in our country today has the option of putting his savings some place, generally let's say in a savings account. And the Government, of course, taxes that. As he gets a sufficient amount of savings, he can start taking advantage of things like investing in a home, investing in common stocks, municipal bonds, things that aren't taxable. There are lots of tax shelters that are almost as effective as pension funds. For the citizen that doesn't work for a company. But pension plans are not really savings plans. They provide benefits in the event of early disability. They provide reasonable benefits when you install the plan where savings plans simply won't develop enough.

Senator CHAFEE. Let's take two fellows. Both are earning $20,000. One works for a company that pays for his pension. He doesn't have to purchase it. The other does not get a pension from the company. Now the one who receives the pension, that's not counted as taxable income to him. He just gets his pension paid for .

Mr. JACKSON.He pays the tax when he receives the benefits.

Senator CHAFEE. When he receives the benefits, yes.

Mr. JACKSON. It's all taxed, isn't it?

Senator CHAFEE. What?

Mr. JACKSON. It's all taxed. Everything that goes into the fund that was ever deducted by the employer. All of the interest that goes into the fund, the sum of it goes out of the fund to the employee in the form of benefits and he pays the tax on it when he receives it, which is our system of taxing individuals.

Senator CHAFEE. When he receives it, yes. But let's take the other fellow who is also making $20,000. He has no pension paid for by the company, so he has to set aside after-tax dollars to purchase the pension of some kind. Is that a fair system?

Mr. JACKSON. Well, you have all these other programs that are available. You have thrift and savings plans that are available. And they are offered by insurance companies, and banks, and other institutions.

Senator CHAFEE. No one is suggesting that his after-tax situation is the same even if he puts money into a Keogh or even an IRA.

Mr. JACKSON. A 401(k) plan.

Senator CHAFEE. He isn't going to come out the same as somebody who is working for Ford Motor Co. and pays nothing for his pension.

Mr. DELANEY. But, Senator, isn't it a timing issue? The person who puts his money away with after-tax dollars and acquires a benefit will be given a deduction for that. He will be able to recover his cost when the payout starts.

For example, if the person were to acquire an annuity contract that is tax sheltered through the accumulation period, he has paid in a certain sum of money for that contract. When distribution starts, he is taxed, but he is given a deduction for a share until he recaptures either his cost in full or an amount that comes out of every payment.

But it seems to me that what we are largely talking about is a timing matter. That may present a lot of problems.

Senator CHAFEE. Let's take an easier case. Take a health program case. One fellow works for a company that pays his entire Blue Cross. The other doesn't and he has to buy it for his family. Now is that the same situation?

Mr. DELANEY. Not since you adjusted the deduction question.

Senator CHAFEE. We all know that. The tax situation for the two is vastly different. One gets all his health insurance paid for. The other doesn't. Now is that fair?

Mr. JACKSON. Well, you are saying it's insurance. I would say it's benefits. And my question is "Do you want to tax the person who is sick, the one who goes to the hospital for 30 days in the course of the year?" He received a massive amount of money. If you want to tax the sick individual on the benefits he got, tax him. The other individual who is also covered by the plan but who didn't collect 1 penny in benefits shouldn't be taxed just because somebody called something insurance. It was practically worthless. Why should he pay a tax on it? He got absolutely nothing. He was handed an empty bag.

Mr. MAMMEL. Senator, I might add a comment on that particular point.

Senator CHAFEE. We are talking about two different things. You are talking about benefits. I'm talking about premiums.

Mr. JACKSON. You are talking insurance. I'm saying there is no insurance here. Consider the group insurance that Ford buys from an insurance company, for example. Ford may send $1 billion to the insurance company, and outside of the money that it takes the insurance company to administer the plan, the insurance company spends the $1 billion on certain of Ford's employees. There is no insurance. Ford is not buying insurance. They are buying benefits and a benefit paying service.

Senator CHAFEE. Thank you very much.

Senator PACKWOOD. Senator Danforth posed an interesting question. He said why should one form of compensation be taxed differently than another. Let's take Senator Chafee's two employees making $20,000 apiece. I see Mr. Sharpe is going to be here from Brown & Sharpe from Rhode Island, so let's assume that they work for Brown & Sharpe. They are both 30 years of age. They both make $20,000. One of them has an ill father and is paying $3,000 or $4,000 a year in extra medical expenses and cannot afford to buy a house. The other one can afford to buy a house. Under our Tax Code we say you can deduct that money. So we do discriminate because we think home ownership is a good policy. I have not seen, with one exception, any of the flat tax proposals that eliminate that deduction. Nobody has had the nerve to say we mean a real flat tax. No more home mortgage interest deductions. No more charitable deductions. No more dependent deductions because we think those are good policies. You take charity. Take the same two people making $20,000. We think it's a good idea that they make a contribution to the program for underprivileged children or some other charity, and so we encourage them to make those contributions. There are only two ways we really use the tax codes for incentives. One is the deduction. And the other is an untaxed, employee benefit or fringe benefit.

I think Senator Danforth misstated the question. The question should be: Are there certain things that we want to encourage beyond what the marketplace would otherwise encourage? Very few people would say nothing beyond the marketplace.

So then the question becomes: Do we encourage employe benefits through the taxation of all of our citizens and set up Government programs to provide the things that we think should be provided beyond the marketplace or do we use the Tax Code to do it? Should it be in the form of tax deductions or nontaxed fringe benefits?

I think the ultimate question you want to ask first is: Are there certain social policies you want to achieve? Do you want people to have adequate pensions or good health care or decent educations or affordable day care? If your answer to those is yes, you then go to the next question: How do we want to encourage that? You have paid out taxation in Government appropriation and Government run programs or through some incentive to the private enterprise system in this country to provide it. And between the two, I much prefer the latter.

Senator DANFORTH. And also to provide a disincentive for cash compensation.

Senator PACKWOOD. Well, that's what we do.

Senator DANFORTH. I mean obviously if you weight the scales in one direction you increase the pressure on the other. And that's exactly what we are saying. We are telling business that we really don't want you to pay people in cash. We are going to tell you how to pay them. We are going to tell you how to pay people, and you do it our way, and we will give you a special tax break.

Senator PACKWOOD. That's also what we are doing with home ownership. We don't want you to rent, we want you to buy. That's a deliberate policy of the Government.

Senator DANFORTH. And the question is not the real flat tax. You know, one rate and absolutely no exclusions for anything. Everybody is proposing a lumpy tax; not a flat tax. [Laughter.]

But I think the question is how many lumps are in it and how big are the lumps. And I think that some people say that somewhere between a 1-page Internal Revenue Code and an Internal Revenue Code that grows in 1,300-page increments by the year—somewhere between the two is a rule of reason. And I think that one thing that we have to ask is if we have exceeded that. Have we, in the Congress, attempted to fine-tune decisions that are otherwise made in the private sector by a proliferation of tax preferences?

And a lot of people think—this is the big Presidential debate. What do we do about the deficit? A lot of people think, well, we have to have some increase in revenue. How are we going to do that? If we have to raise revenue, how are we going to do it? And we can do it, I think, in one of a number of ways.

One thing we can do is what we have been doing the last 2 years and that is to have another huge code and have a lot of little items—a huge tax bill and have a lot of little items in it. The other thing we can do is raise rates. The President has indicated he doesn't want that.

And the third thing we can do is broaden the base. And I take it this is what the Treasury Department is studying right now. Can we broaden the base of the Tax Code so that we can have a fairer tax so that people similarly situated are treated more or less the same. And I think if we are going to have a fairer tax and a simpler tax, we are going to have to look at some very popular preferences that exist in the code. And we are going to say is it fair, even if there are people who love them, is it fair to have a code that is this oriented to this extent—toward fine tuning and toward manipulation of decisionmaking in the private sector, and the treating people who are otherwise similarly situated in very different ways. And I think that when you have a code and one guy is on one side of the street and the other on the other, and they have basically the same income, and one finds his income taxed and the other finds his income largely untaxed, that raises the question of equity.

So I just wanted to raise my usual yellow flag, Mr. Chairman, on the question of fringe benefits.

Senator PACKWOOD. I want to come back to the use of the Tax Code. Senator Danforth is the most eloquent, able supporter and innovator in the area of research and development credits which he thinks are good. Those should be allowed because businesses need those. Some businesses use them more than others.

I support him. I think they are good credits. But what this really boils down to is who likes which programs. If you don't like the programs, then you use the argument we shouldn't use the Tax Code to do it. If you do like the programs, you probably have no objection to using the Tax Code, and especially if you think you are not going to get any moneys appropriated for your program. In which case then you would think the Tax Code is the next best alternative.

Again, it comes to those two philosophies in terms of broadening the tax base, in terms of where do we get the revenue. That should not be a problem for this country. If we have the will to raise it, we have the capacity to raise it. If you exempted all income, from the income tax in this country, that does not mean that you couldn't raise sufficient revenues to run this government. There are all kinds of taxing devices other than income taxing devices that could be used. The windfall profits tax is a perfect example. The windfall profits tax passed this Congress in 1978, as I recall, on the assumption that it was a tax on oil companies. Turns out it isn't. It's an excise tax and you pay it as the oil comes out of the ground, whether your company makes a profit or not. Who does that tax get passed onto? Every single person that buys food or heats their home or drives their car. It is passed right on through the system with no exemptions. So can we raise the money? Yes; that tax could be raising a lot more money than it raises now had our expectations then of what oil prices were going to do continues. We were assuming oil prices of $45 to $50 a barrel by now, and we can still raise it.

If we want to pass a tax, it will need broad based support. All we will have to do is call it the corporate malefactors tax. We can pass it without any difficulty. But we can raise the money that is necessary to close the deficit if we are going to go the route of taxation to do it.

The fact that we eliminate certain things from coverage under the income tax does not mean we can't raise enough revenues to run the government.

Any other questions?

[No response.]

Senator DANFORTH. Not after that. [Laughter.]

Senator PACKWOOD. I still support the research and development credits. [Laughter.]

Senator PACKWOOD. Thank you. Now we are ready for Mr. Hurley, the vice president of Chase Manhattan Bank; and Father William J. Byron, president, Catholic University.

The two of you have been very patient. I have been watching you out there in the audience.

Mr. Hurley, go right ahead.

STATEMENT OF JOHN HURLEY, VICE PRESIDENT, CHASE MANHATTAN BANK, NEW YORK, NY, ON BEHALF OF THE AMERICAN SOCIETY FOR TRAINING AND DEVELOPMENT, INC., WASHINGTON, DC

Mr. HURLEY. Good morning, Mr. Chairman. I'm John Hurley, vice president and a director at the Chase Manhattan Bank of New York. I'm here to present the views of the American Society for Training and Development on employer provided educational assistance.

The American Society for Training and Development is especially pleased to testify in support of employee educational assistance since our society represents those in the work place who are responsible for employer-sponsored employee training and education programs. We have nearly 50,000 members in our national organization, and in the 141 chapters throughout the country. Our members are engaged in training and retraining our Nation's work force from entry level youth to top management.

I currently serve on the Society's National Issues Committee, and would like to convey the message that the decision of the recent House-Senate Tax Conference Committee in June not to extend section 127 of the tax code carries a profoundly negative message from Congress.

As you all know, employer provided educational assistance provisions became a part of the tax code in 1979. The pre-1979 tax rules, which now again apply for employer educational assistance, resulted in demonstrably severe discrimination against lower level members of the work force—women and minorities—disproportionately. The job relatedness test for excluding educational aid from employee income tax, Treasury regulation 162–5, represented a clear disincentive from the Federal Government to lower paid employees who want to achieve upward mobility and acquire new knowledge and skills and cope with changing work place needs. These discriminatory Treasury regulations seem to be in direct conflict with civil rights law which provide for affirmative action and upward mobility programs for minorities and women.

These old rules especially tax employees who take educational initiatives to qualify for new or more advanced jobs. The same job relatedness test amounts to a broad disincentive to the entire Nation's work force for acquiring new job knowledge and skills and does so at a time when a work force of the highest quality is essential for meeting the fierce and growing international economic competition. The principle of the pre-1979 law is vividly illustrated by the realization that those dislocated workers who get retraining under the new labor agreements in the auto and telecommunications industries will probably have to pay income tax on the value of the retraining they receive.

Data show that extending the statute would result in increased revenues, not revenue losses, for the Federal Government, through increased taxes from the higher incomes of those who advance their economic status through more occupational education and training. There are also other national economic benefits such as improved work force productivity and lower unemployment costs.

The job-relatedness test itself caused extensive administrative confusion in interpretation before 1979. Wide variations in interpretation of what was job related were increasingly evident before 1979 among employers and among Internal Revenue Service decisions. Retroactive tax liabilities and tax court litigation were growing around this issue.

Taxing employees for employer educational assistance is inconsistent with the Federal Government encouraging more involvement of employers, less regulation, and more education and training of the work force, especially through cooperative programs between educational institutions and the private sector. Employee educational assistance is a positive example of a productive social goal easily achieved through the tax code rather than through direct appropriated spending programs administered through Federal bureaucracies.

We at Chase Manhattan, are much involved in these programs and we are still working to resolve differences between ourselves and the IRS for cases prior to 1979. There are court cases that date back to 1973 over the confusion caused by regulation 162-5. We have recently announced the impact of the return to 162-5 with a resulting decrease of over 50 percent in participation in this particular program. The majority of those people who have discontinued the program come from the lower level work force, including minorities and women.

I'm about at the end of my time here so I will stop at this point.

Senator Packwood. Thank you.

[The prepared written statement of Mr. Hurley follows:]

STATEMENT OF

JOHN HURLEY

VICE PRESIDENT

CHASE MANHATTAN BANK

ON BEHALF OF

AMERICAN SOCIETY FOR TRAINING AND DEVELOPMENT

ASTD

TESTIMONY SUPPORTING EMPLOYEE EDUCATIONAL ASSISTANCE

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

July 30, 1984

SENATOR BOB PACKWOOD

CHAIRMAN

American Society for Training and Development

SUMMARY

TESTIMONY ON EMPLOYER EDUCATIONAL ASSISTANCE

The 50,000 members of the American Society for Training and Development strongly support a reinstatement and permanent extension of Section 127 of the tax code which provides an exclusion of employer educational assistance from employee income. The decision of the tax conference committee in June not to extend that statute carries a profoundly negative message from Congress:

- Employer-provided educational assistance provisions became a part of the tax code in 1979 (Revenue Act of 1978). The pre-1979 tax rules, which now again apply for employer educational assistance, resulted in demonstrably severe discrimination against lower-level members of the work force -- women and minorities -- disproportionately. The job relatedness test for excluding educational aid from employee income tax (Treasury regs. 1.162-5) represented a clear disincentive from the federal government to lower paid employees who want to achieve upward mobility and acquire new knowledge and skills and cope with changing workplace needs. These old rules especially tax employees who take educational initiatives to qualify for new or more advanced jobs. Data clearly demonstrate an increase in participation rates by non-exempt (non-management and non-professional) employees since 1978.

- The same job relatedness test amounts to a broad disincentive to the entire nation's work force for acquiring new job knowledge and skills -- at a time when a work force of the highest quality is essential for meeting the fierce and growing international economic competition. The principle of the pre-1979 law is illustrated vividly by the realization that those dislocated workers who get retraining under the new labor agreements in the auto and telecommunications industries will probably have to pay income tax on the value of the retraining they receive.

American Society for Training and Development

- Projections show that extending the statute would result in increased revenues, not revenue losses for the federal government, through increased taxes from the higher incomes of those who advance their economic status through more occupational education and training. There are also other national economic benefits such as improved work force productivity and lower unemployment costs.

- The job-relatedness test itself caused extensive administrative confusion in interpretation before 1979. Wide variations of what courses were job-related were increasingly evident before 1979 among employers and among Internal Revenue Service decisions. Retroactive tax liabilities and tax court litigation were growing around this issue.

- Taxing employees for employer educational assistance is inconsistent with the federal government encouraging more involvement of employers, less regulation, more education and training of the work force, especially through cooperative programs between educational institutions and the private sector. Employee educational assistance is a positive example of a productive social goal easily achieved through the tax code rather than through direct appropriated spending programs administered through federal bureaucracies.

A simple, permanent extension of Section 127 would be in the best interests of all. It would directly help those in the work force who want to advance themselves, it would bring increased revenues to the Treasury, and it would help improve the quality of the national work force.

Good Morning. I am John Hurley, Vice President at Chase Manhattan Bank of New York. I am here to present the views of the American Society for Training and Development on employer-provided educational assistance (Section 127 of the tax code). The American Society for Training and Development is especially pleased to testify in support of employee educational assistance since our Society represents those professionals who are responsible for employer-sponsored employee training and education programs. We have nearly 50,000 members in our national organization and in the 141 chapters throughout the country. Our members are engaged in training and retraining the nation's work force from entry level youth to top management. I currently serve on the Society's National Issues Committee.

The employer-provided educational assistance provisions of the tax code (Section 127) eliminated the problems of the previous Treasury regulations which were causing administrative confusion in interpretation with increasing tax court litigation.

This tax exclusion also eliminated the general discriminatory effects against non-supervisory employees and women and minorities. These discriminatory rules seemed to be in direct conflict with civil rights programs which promote affirmative action and upward mobility for women and minorities. By broadening the employee income tax exclusion for employer educational assistance, more employees have utilized employer educational aid.

In 1978, ASTD submitted survey data which showed that employee participation was three times greater when the employer's practice was not to withhold income tax for educational aid. Thus, greater proportions of the work force, and especially those at lower income levels, began participating in employer-provided educational assistance when Section 127 took effect. ASTD had the privilege of working with Senators Packwood, Javits and Moynihan in 1978 in developing the employer educational assistance provisions which were incorporated in the Revenue Act of 1978. We are attaching data on the increase in participation rates, especially for non-supervisory employees, and information on other studies of tuition aid.

These provisions have worked well for five years. We have heard of no abuse of Section 127 of the code. And now as a result of the June Congressional tax conference, a retroactive extension of Section 127 was eliminated from the recent tax bill.

Many employers, fully expecting an extension, are now faced with withholding for back taxes on educational assistance programs from January 1, 1984, as well as possible penalties. Employees will have to pay income and social security taxes on educational assistance that enhances their job competence, their career, and the national economy. Especially hard-hit are those workers who are being retrained under new labor agreements in the auto and telecommunications industries. In addition to serving as a deterrent to retraining for the displaced or about to be displaced worker, this is a negative signal from Congress for a positive, new kind of labor-management cooperation. The United Auto Workers (UAW) has negotiated training programs worth approximately $10 million with General Motors and Ford. Workers can be reimbursed for as much as $1,000 a year in tuition expenses over a four year period. Some of these programs are preparing workers for jobs unrelated to the automotive industry. And the Communication Workers of America and the companies of the former Bell System have agreed to establish personal and career development training programs for workers faced with employment security problems. Those educational aid programs may now be taxable to workers because of the absence of Section 127.

Educational aid programs are also found at many small companies. Machine tool shops, which have an average of 25 employees, frequently send their machinists and die and mold makers to technical schools and junior colleges for training in new skills. The industry has a large number of apprentices who may now have to pay taxes on the value of that training for more advanced jobs.

And employers in high technology and information processing industries like banking have enthusiastically supported continuing education courses for engineers, scientists, technicians, and professionals in areas such as international monetary policy. One high tech employer told us that "continued education for our employees is a must, not a luxury."

We have heard from ASTD members in the banking industry who are experiencing drops of as much as 50 percent in registrations for banking courses since Section 127 expired. A large proportion of these enrollments are women and minorities trying to improve their careers. A typical profile for 25 bank employees in educational assistance programs includes: 17 females and 8 males; 17 foreign born and 8 born in the U.S.; 14 bank clerks, 3 secretaries and 6 supervisors, and only 2 bank officers.

We have seen many cases of educational assistance helping lower paid employees improve their skills. One example is the Continuing Education Institute of Massachusetts. This non-profit institute provides basic education courses (reading, math, writing, etc.) through company-sponsored tuition aid programs. A study of the Continuing Education Institute's 1982 and 1983 graduates showed that 22 percent had received promotions and 50 percent had gone on to additional education and training. Seventy-six percent of the students were women; 63 percent were minorities; 25 percent had been on welfare at one time. Twenty-five percent had never attended high school, and 32 percent were born outside the U.S. Only 12 percent of the employees were reading at high school level when they enrolled. This is just one example demonstrating that educational assistance is not a "perk" for highly compensated employees. Now these employees will have to pay taxes on these basic education courses.

Our data shows that educational assistance is offered to a broad cross-section of employees and since 1978, more lower-paid employees have participated. Section 127 clearly states that employer educational assistance programs cannot discriminate in favor of officers, owners, or highly compensated employees. In addition, educational assistance should not be considered a "perk" since Section 127 specifically states that the educational assistance cannot be provided to employees in lieu of additional compensation, or on a salary reduction basis.

Without the specific rules of Section 127, employers will have to go back to the confusing, vague and discriminatory pre-1979 regulations on educational assistance. Employers must decide whether the educational assistance they are providing each employee meets the job-relatedness test. Inevitably this has led to wide variations in the tax treatment of similar situations.

We are seeing this great confusion again from employers from all over the country who have called our national ASTD office with questions about penalties and rules for withholding.

As the Joint Taxation Committee said in its explanation of the inclusion of employer education provisions of the Revenue Act of 1978, "The job-related distinction often seems both ambiguous and restrictive... If a person with little or no work experience is employed in an entry-level position and receives training from his employer to advance to a job requiring some greater skills or experience, the value of the training may be taxable. This may discourage self-improvement."

During the recent tax conference, the House conferees insisted on applying FICA (social security) and FUTA (unemployment) taxes on educational assistance. The combined employee-employer contribution amounts to about a 16 percent tax on education. This disincentive would again hamper the education of employees who are trying to upgrade their skills and earn a higher taxable income. In addition, employers would still have to make withholding judgments and apply the job-relatedness test of pre-1979 on all educational assistance to determine which courses are subject to FICA and FUTA.

ASTD and our coalition of numerous business, trade and professional associations, unions, educational institutions, and individual employers strongly support a simple reinstatement and permanent extension of Section 127 of the tax code. A competent, well-trained work force is central to the economic vitality of our business and industrial enterprise. With fierce international economic competition, it is imperative that we build the highest quality human capital and work force productivity.

Employees are now faced with rapidly changing needs for new job knowledge and skills. The quickening pace of change in technology, the economy, work force demographics, and labor/management contract agreements are creating even more intensive demands for work and career-related education and training. Employer-provided educational assistance is an effective means to help upgrade skills of American workers.

As we pointed out in 1978, the measure has the added benefit of simplifying the administration of the tax code and should increase the earning power and tax revenue from participating employees. Estimates of the number of employees receiving educational assistance from their employers range from 2-3 million to 7 million (estimates from data gathered by the National Center for Education Statistics). We can take the lowest estimate of 2 million employees to make some economic assumptions. An increase in knowledge and skill results in an increase of only 2% in the average income of these two million people, and their average income is about $17,000 per year. If their collective tax bracket is about 25%, Treasury would collect $170 million in additional income taxes from people who are improving their economic well being.

In addition, for every one percent increase in unemployment, the cost to the Treasury is $30 billion in unemployment insurance, welfare support, loss of income taxes, etc. If employer-provided educational assistance helps only one percent of the two million recipients to stay off the unemployment roles for half a year, the savings to the government would amount to about $300 million. These valid arguments in favor of national economic benefits such as improved work force productivity and lower unemployment costs far outweigh the meager revenue loss of less than $40 million that the Treasury estimates for employer educational assistance.

Everyone benefits from a retroactive extension of Section 127 -- the employees, the employers, and the nation's economy. We urge Congress to reinstate employee educational assistance in the tax code. We stand ready to help the Senate Finance Committee pass legislation this year.

102-07
7/25/84

American Society for Training and Development

EMPLOYER TUITION REFUND PLAN
EMPLOYEE UTILIZATION AT ONE LARGE COMPANY
CALENDAR YEAR 1982

TOTAL EMPLOYEES: 40,063

Annual Salary Ranges	Percentage of Employees by Salary Range	(Cumulative)	Percentage of Employees in this Range Completing a Course	Percentage of Participating Employees in this Range	(Cumulative)
$5,000-$19,999	23%	23%	11.0%	35%	35%
$20,000-$24,999	17%	40%	8.1%	18%	53%
$25,000-$29,999	23%	63%	5.3%	17%	70%
$30,000-$34,999	10%	73%	10.5%	14%	84%
$35,000-$44,999	12%	85%	6.5%	11%	95%
$45,000-$64,999	10%	95%	3.7%	4%	99%
$65,000 and over	5%	100%	.4%	1%	100%

Summary

- 40% of the employees earn less than $25,000. Of these employees, 53% completed courses.
- 73% of the employees earn less than $35,000. Of these employees, 84% completed courses.
- Highest rate of participation is by employees in the lowest salary range, employees making less than $20,000 per year (11%).
- Of all employees who participate, the greatest percentage are those in the lowest salary range (35%).

SAMPLE EMPLOYEE EDUCATIONAL ASSISTANCE DATA

Company A

Percent increase in participation by compensation level from 1977-1982:

Employee Class	% Increase (1977-1982)
Management	20%
Professional	26%
Non-exempt (non-supervisory)	46%
Hourly	30%

Company B

Years	% Increase in tuition aid participation
1977-1983	
Exempt Employees	45%
Non-Exempt Employees	50%

Education Reimbursements:

Year	~~Exempt~~ (Supervisory)	Non-Exempt
1977	$19,855	$28,288
1982	$62,523	$65.409
1983 (Estimate)	$75,850	$79,350

Company C

Tuition Aid participation in 1983:

Total participants:	1,583
Management	503
Non-management	1,035
White male	468
Minority male	139
White female	560
Minority female	371

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Company D

Employee Class	1977	1981
Management	10%	10%
Professional	44%	39%
Clerical/Technical Nonexempt Salary	33%	34%
Hourly	14%	17%
Male participants		4,738
Female participants		2,375

Company E

Employee Class	1977	1981
Management	3.97%	5.22%
Professional	10.23%	10.40%
Nonexempt Salary	6.95%	9.17%
Hourly	2.00%	2.64%

Company F

"The average percent of the population participating in tuition aid from 1979-1982 was 50% higher than in the years 1975-1978."

1982 Data on Tuition Aid by compensation level:

Employee Class	% in T.A.	% in Workforce
Exempt (Supervisory)	49%	49%
Nonexempt (non-supervisory)	51%	50%
Executive	0%	1%
Male	68%	75%
Female	32%	25%

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Company G	1978	1982
Participants in Tuition Aid	7,500	13,509
% participation in Tuition Aid	3.4%	6.3%
% women participants		32.0%
% women in company workforce		25.0%
% administrative (clerical, support) participants		25.0%
% administrative in company workforce		18.0%
% blue collar participants		5.0%
% blue collar in company workforce		9.0%
% manager participants		12.0%
% managers in company workforce		14.0%

Company H

	Educational Assistance Courses Completed
1978	174
1981	580

"65.1% increase in participation rates from 1978-1981".

Company I

Year	Number of Participants	% of Employees Participating
1977	2,319	4.83%
1978	2,324	4.84%
1979	3,421	9.27%
1980	5,360	10.80%
1981	4,857	9.83%
1982	6,047	12.40%
1983	6,500 (Estimate)	13,50%

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Company J

Years	%Increase in Participation
1974-1981	+ 139%
1974-1982	+ 157%

Company K

1983 Tuition Aid Data

Total company workforce	600 employees
% participating in T.A.	10%

Company L

1978	261 tuition aid participants
	3,909 eligible employees
	6.7% tuition aid participation rate
1983	572 tuition aid participants
	4,300 eligible employees
	13.0% tuition aid participation rate

EMPLOYEE EDUCATIONAL ASSISTANCE

Sample data showing changes in participation rates for an organization's work force:

Organization	Year	No. of Employees Participating	% of Change
Company 1	1978	328	+85 %
	1981	606	
Company 2	1977	5,784	+23 %
	1981	7,107	
Company 3	1978	1,174	+40 %
	1982	1,641	
Company 4	1978	7,500	+80 %
	1982	13,509	
Company 5	1977	255	+109%
	1982	535	
Company 6	1977	5,784	+40 %
	1982	8,093	

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TUITION AID SURVEYS

1984 Valley National Corp.
N=75 96% with tuition assistance programs

1984 Jos. O'Neill - Conference of Small Private Colleges
N=655 96% with t.a. programs

1980 Jos. O'Neill - Conference of Small Private Colleges
N=358 98% with t.a. programs

1979 Industrial Relations News
N=363 employers 90% with t.a. programs

1979 Conference Board - 79% with t.a. programs for non-exempt production & operations personnel; 91% for non-exempt office and clerical personnel.

1978 AT&T
100 of Fortune 500 93% have t.a. plans

1977 Employers Assn. of Detroit
96% have t.a. plans

1977 BNA
N=141 employers, ½ with 1000 employees or more, and ½ with less than 1000 • 91% have t.a. plans

1977 City of Milwaukee
28 private sector organizations - 100% with t.a.
13 public sector organizations - 77% with t.a.

1977 American Assn. of Industrial Management of New England

hourly non exempt employees	77%
clerical, technical salaried non-exempt employees	86%
supervisory, professional exempt employees	89%

1976 Adult Education Council of Greater St. Louis
Business and Industry = 72% with t.a. programs
Hospitals = 81% with t.a. programs

1975 Conference Board
N=610 firms of 500 or more employees
89% have t.a. programs

1975 Miami University and General Accident Group Insurance Co.
over 90% have t.a. programs

no date Management Resources Assn., Inc. (Milwaukee)
91% of employees of a total 19,538 employees in 61 organizations covered by tuition aid plans

DRAMATIC INCREASE IN EMPLOYER EDUCATIONAL SUPPORT

Data from the National Center for Education Statistics (U.S. Dept. of Education) strongly suggest that the now-expired Employee Educational Assistance tax legislation greatly encouraged those in the work force to take advantage of employer aid for education and retraining to improve job performance and to get new jobs.

According to NCES' *Participation in Adult Education* reports for 1978 and 1981, the number of adult education courses having business and industry as a source of payment rose nearly 74% during those three years. The new law, which stopped the Internal Revenue Service from making employees pay income tax on employer education aid, took effect on Jan. 1, 1979. It seems reasonable to conclude that excluding employer education aid from employee income tax helped substantially to increase work force participation in continuing education.

Moreover, some 92% of all adult education courses supported by business and industry in 1981 were taken for job-related reasons. Further, 56% of the participants in adult ed courses were women.

We should point out that these data reflect the "business and industry" category only. Because of inconsistencies of survey questions between survey years and other problems, we have not tried to include data relating to aid from "private organizations," partial support, governments as employers, etc.

The NCES data also indicate that the new law achieved its intended effect of getting more lower-paid people into continuing education. Traditionally, NCES data have shown that participation in adult education correlates closely with past education and level of income—the more prior education and the higher the income, the more likely one participates in more education. But the comparison of adult ed participation by occupation before and after the law was changed shows substantial increases in the rates of participation of lower-paid occupational groups.

Below is a listing of changes in the rates of participation in adult ed by occupational groups:

Occupation	*Percent Change of Rate of Participation 1978-1981*
Non-farm laborers	+28.1
Transport equipment operatives	+24.6
Operatives, except transport	+20.0
Craft and kindred workers	+18.6
Service workers, including private household	+17.0
Managers and administrators, except farm	+15.3
Sales workers	+ 8.6
Clerical workers	+ 4.2
Professional, technical and kindred workers	1.2
Farm workers	- 15.0

These data and other evidence clearly indicate that not taxing employees for improving themselves encourages people to become better educated and more competent in their work. With the nation facing continually changing demands for new work force knowledge and skills—because of fierce foreign competition, changing work force demographics, and the onrush of new technology—national policy that discourages work force development seems completely out of order.

Should Congress not extend Section 127 of the Internal Revenue Code which expired Dec. 31, or impose regulatory disincentives on employers or employees, we can surely expect to see downturns in these trends for employer investment in the nation's human capital.

American Society for Training and Development

BUSINESS MOST POPULAR ADULT ED COURSE

From the new *Digest of Education Statistics 1983-84* by the National Center for Education Statistics (U.S. Dept. of Education):

Number of participants in adult education	21,252,000
Percent of total adult population	12.8%
No of courses taken in adult education (top six)	
Business	8,564,000
Health care and health sciences	3,993,000
Engineering and engineering technology	3,654,000
Education	2,926,000
Philosophy, religion and psychology	2,377,000
Physical education and leisure	2,373,000
Arts: visual and performing	2,373,000

Income levels of participants	
$50,000 and over	7.7%
25,000 - 49,000	34.4
24,000 & under	54.9
Not reported	7.7

WHO AND HOW EMPLOYERS RETRAIN

Some findings from interviews with more than 300 human resource executives of Fortune 1500 firms (84% manufacturing) by ITT Educational Services, Inc.:

Whose jobs are most affected by the need for retraining in your organization?

Senior management	9%	Technicians	54%
Middle management	29	Other workers	24
Secretarial/clerical	40		

At your company, is retraining carried out by:

Existing personnel	29%	Some combination of the above	62%
Hiring additional personnel to conduct training	2	No retraining taking place	3
Training employees externally	3	Don't know/no answer	2

Although 62% use a combination of sources, they say they prefer managing their own training problems without outside intervention.

How likely would you be to rely on the training services provided by the following?

	Very or Somewhat Likely	*Unlikely or Very Unlikely*	*DK/NA*
Outside vendors offering retraining services	68%	29%	4%
Industry trade associations	55	41	4
American Management Associations	38	58	4
Chambers of Commerce	19	76	4

With reference to outside vendors, for your industry, where does most worker retraining take place?

Public and private vocational schools	64%
Two-year community colleges	44
Universities	37
Other	26
Through correspondence courses	20

In your opinion, who should have the major responsibility for funding worker retraining?

The employer	38%
Private Industry Councils	1
The employee	0
Government	0
Unions	0
Some combination	60

94% of those surveyed do retrain workers, at least in a few instances, but presently, retraining is not the most consistently used solution for coping with workers' obsolete skills. Hiring new employees with the required skills tops the list. However, 74% said that most of their employees were positively inclined toward retraining, not resistant.

Among the ITT observations about the survey: 1. Business is not averse to retraining employees, although currently prone to replace rather than retrain and 2. employers and employees need to share responsibility for retraining.

More information about the study may be obtained from LAWRENCE G. LaBEAU, Director of Corporate Relations and Advertising, ITT Educational Services, Inc., 3500 DePauw Blvd., P.O. Box 68888, Indianapolis, IN 46268.

ASTD National Report January 30, 1984

MANAGEMENT'S SHARE OF TRAINING DROPPING

Management Development, Organizational Development and Supervisory Training account for one-third of all training purchases in the United States, according to a new study from Hope Reports. Five-year spending on these subjects, however, has not kept pace with spending for other training topics. Revenues from off-the-shelf programs, custom-designed training and generic seminar presentations for these three subjects increased 88% from 1977 to 1982, while as a group, sales of 17 other topics rose 124% over the five years.

Five of the topics jumped more than 200% in sales over five years compared to the increase of 111% for all training subjects. The leading "hot" topic, based on ten criteria, is Data Processing Training, which ranked third of all topics in gross sales in 1982.

The full report is being released in two volumes, *Hope Reports U.S. Training Business*, Vol. I, and *Hope Reports Training Business Directory*, Vol. II.

Inquiries should be sent to Hope Reports, 1600 Lyell Ave., Rochester, NY 14606.

ASTD National Report February 27, 1984

EMPLOYEE TUITION AID SURVEY DATA

More than 96% of the responding companies in a recent survey had tuition reimbursement plans for their employees. The survey was done by JOSEPH P. O'NEILL of the Conference of Small Private Colleges with a questionnaire mailing to the Industrial *Fortune* 500 and the Service *Fortune* 500 companies. O'Neill's report covers 655 responses representing more than 17 million employees. Other findings:

26.4% required that the employee pay part of the tuition

- At 130 companies, employees paid 10% to 25%
- At 37 companies, employees paid 26% to 50%
- No company required employees to pay more than 50%

Fewer than 30 companies varied the percentage according to grade received

Explicit limits on tuition reimbursement were reported by 45.3% of the companies. Of the 158 companies that stated dollar limits, the ranges were:

\$ 200 to \$ 499	10 companies
500 to 999	42 companies
1000 to 1499	50 companies
1500 to 2000	40 companies
more than 2000	16 companies

86% of the respondents reimbursed only upon "satisfactory completion"

60% give new employees immediate eligibility for tuition aid

A report on this survey of corporate tuition aid programs may be obtained from Joseph P. O'Neill, Conference of Small Private Colleges, P.O. Box 24, Princeton, NJ 08542.

• American Society for Training and Development

96 PERCENT OF FIRMS STUDIED OFFER TUITION AID

Here are some findings from a new survey of Employee Tuition Aid Assistance programs in 65 financial institutions and 10 industrial and utility firms in the western U.S. The study was conducted by JOHN KILROY of the Valley National Corp., Phoenix, AZ.

- 96% of the responses offered tuition assistance
- 100% paid for undergraduate courses
- 98% paid for graduate courses
- 73% paid for work-related seminars
- 76% paid for non-credit courses
- 22% reimbursed at time of enrollment
- 66% had no dollar limit on reimbursement
- 62% indicated there was a tenure requirement for participation
- 87% required supervisor approval
- 20% offered loans for tuition
- 43% offered tuition aid to part-time employees

Among the study recommendations: Business and industry should establish a stronger link locally with education in the development of courses to meet the future needs of the work force and the community.

For more information: John Kilroy, Program Development Officer, Valley National Bank of Arizona, Headquarters B311, P.O. Box 71, Phoenix, AZ 602/261-1485.

Washington Post   July 25, 1984

William Raspberry

Only the Little Guy Gets Hurt

It wasn't that anybody set out to do a number on the little guy when Congress passed its tax bill last month. It just happened that way.

The legislators, looking for ways to make a sizable dent in record-level federal deficits, naturally focused on such things as abusive tax shelters. The big-time lobbyists, hoping to do something nice for their corporate masters, spent their time pushing for new and improved loopholes. The advocates of the poor worked to restore some of the welfare benefits that had been taken from low-income working women and also to force the states to extend Medicaid coverage to more poor families.

It isn't surprising, then, that no one paid much attention to a proposal dealing with the taxation of employer-paid educational benefits.

The effect of the little amendment that didn't pass is that workers whose employers pay all or part of the cost of their non-mandatory outside training may be subject to income taxes on the value of the employer's contribution. If your boss picks up a part of the tab for your computer course or your shorthand training or your law-school study, he will have to withhold taxes on the cost of the training—unless it is a condition of your employment.

In big-picture terms, it isn't that much of a deal—an additional $25 million to $40 million in federal revenues, according to Bob Craig, a vice president of the American Society for Training and Development.

But, says Craig, its heaviest impact will be on low-level employees.

Until a few years ago, the rule was that all employer-paid training was taxable to the employee unless its purpose was "to maintain or improve skills" in the employee's present job. Then in 1978, Sen. Bob Packwood (R-Ore.) pushed through an amendment that exempted educational benefits from taxation. But the legislation had a "sunset" provision that would render it void after five years unless Congress voted to extend it. Two successive attempts to extend it, the second coming during last month's debate, failed. The law now reverts to what it was before 1978.

But why is it harder on low-level employees than on executives who also receive educational benefits? The culprit, says Craig, is the requirement that the training relate directly to the employee's present job. Almost any training can be deemed essential to an executive's present job. (The only training specifically excluded from tax exemption is for "sports, games and hobbies.") According to Craig, the low-level employee is more likely to undertake outside training not for his present job but to improve his chances for a promotion. As the law now stands, that makes it taxable—even if the promotion never materializes.

"In fact," says Craig, "employers who have not withheld taxes since Dec. 31, 1983, when the Packwood amendment expired, have to withhold back taxes." They may even be subject to interest charges and penalties.

"What the law does is to penalize those ambitious low-level people who are trying to get ahead in their careers, who are trying to learn new skills that will qualify them for promotions," says Craig, whose Washington-based association is composed of people engaged in employer-provided education and training, from entry-level remediation to executive development.

"People at the lowest levels can relate very little of their training to exclusions for tax purposes. Executives can exclude virtually everything."

So why didn't Craig, whose purview is government relations (i.e., lobbying), lobby harder for extension of the Packwood amendment?

"You want the truth?" he says. "Everybody expected it to pass."

American Society for Training and Development

Senator PACKWOOD. Father, let me read who you are representing today because if you read them all, it will use up all of your 4 minutes. [Laughter.]

Father Byron is speaking on behalf of the American Association of Community and Junior Colleges, the American Association of State Colleges and Universities, the American Council on Education, the Association of American Universities, the Association of Catholic Colleges and Universities, the Association of Jesuit Colleges and Universities, the Association of Urban Universities, the Council of Independent Colleges, the Council of Graduate Schools in the United States, the National Association of College and University Business Officers, the National Association of Independent Colleges and Universities, the National Association of Schools and Colleges of the United Methodist Church, the National Association of State Universities and Land-Grant Colleges, and the National University for Continuing Education Association.

Senator DANFORTH. Did I hear the National Association of Schools and Colleges of the United Methodist Church?

Senator PACKWOOD. You did. [Laughter.]

Senator DANFORTH. Vatican three. [Laughter.]

Senator PACKWOOD. Go ahead, Father.

STATEMENT OF REV. WILLIAM J. BYRON, S.J., PRESIDENT, CATHOLIC UNIVERSITY OF AMERICA, WASHINGTON, DC

Father BYRON. Thank you, Mr. Chairman, and members of the subcommittee. I'm accompanied by Mr. Sheldon Steinbach, who is the general counsel of the American Council on Education.

We are here to express the concern of the higher education community at the expiration of section 127 of the Internal Revenue Code, the Employee Educational Assistance Act. It is our hope that the Congress can act at the earliest opportunity to reinstate this provision.

Section 127 was enacted to eliminate inequities and to remedy inefficiencies in programs of educational assistance for employees. Prior to 1978, an employee could claim a deduction for amounts expended for education only if the education related solely and directly to the employee's current job position. This limitation on deductibility of educational expenses severely limited the ability of lower compensated employees to seek job advancement and also limited the ability of an employer to promote the training and technological advancement of his or her work force.

Section 127 is not in any strict sense a fringe benefit since educational assistance cannot be provided to employees in lieu of additional compensation. Section 127(b)(4) specifically provides that a qualified program must not allow employees a choice between educational assistance and remuneration includible in gross income. The prohibition on use of salary reduction plans under section 127 means that educational assistance programs are adopted by employers on the basis of a calculated judgment as to their own long-term business needs. Employer financing of educational assistance programs ensures that the programs maintain a primary business rather than compensatory focus. We do not seek any change in this aspect of section 127. The concern I am expressing today is with the extension, not with any expansion, of section 127.

Throughout 1983, with the sunset date of section 127 approaching, representatives of both industry and higher education attempted to convince the Treasury and the Congress of the need to preserve the provision. Although the legislative timetable was unsettled, there was evidence during 1983 and increased evidence in 1984 of strong support for employee educational assistance, and there was good reason to believe that action would be taken to extend, or during 1984 to reenact, section 127. On this basis, and recognizing the importance to both business and individuals of sustained and stable educational opportunities, many employers maintained established programs and continued to treat educational assistance payments as amounts excluded from gross income.

In light of the legislative situation, this was a reasonable and responsible practice, and I believe that under the circumstances no penalties should be imposed under normal IRS practice with respect to either income tax or employment taxes which might be owing for periods after 1983. I also believe, however, that this should not be left for determination, with needless expenditures of effort and expense, in an individual audit context. If action on section 127 should for any reason not be retroactive to December 31, 1983, I would ask the Congress for an expression of its intent that no penalties be applicable with respect to the continuation of the tax treatment provided by section 127 during the period, I hope a short one, of its statutory lapse.

The cost of section 127 is relatively slight, but the return both to employers and to society is substantial. Our Nation's needs for employment retraining and technological advancements and opportunities for the traditionally underemployed are so great that it seems shortsighted, indeed, to eliminate a program that in a few years has achieved significant demonstrable success.

Mr. Chairman, I have remarks in my full testimony about faculty housing.

Senator PACKWOOD. Why don't you go ahead and cover that? I realize your time is about up, but you are the only witness that is touching upon this particular subject. It starts on page 5 of your testimony.

Father BYRON. I can give a digest of it. Recent tax legislation imposed a moratorium until the end of next year on the issuance of any rules or regulations providing for taxation of certain qualified faculty housing furnished in 1984 and 1985. At the same time, Congress failed to deal fairly, we think, with four New England schools which are vulnerable for past years. They are Wesleyan, and Amherst and Smith and Wellesley. This subject should be resolved before the end of the present Congress.

Senator PACKWOOD. Thank you very much.

[The prepared written statement of Father Byron follows:]

TESTIMONY

TO THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

UNITED STATES SENATE

JULY 30, 1984

PRESENTED BY

REV. WILLIAM J. BYRON, S. J.

PRESIDENT

THE CATHOLIC UNIVERSITY OF AMERICA

ON BEHALF OF

American Association of Community and Junior Colleges
American Association of State Colleges and Universities
American Council on Education
Association of American Universities
Association of Catholic Colleges and Universities
Association of Jesuit Colleges and Universities
Association of Urban Universities
Council of Independent Colleges
Council of Graduate Schools in the United States
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Schools and Colleges of the United Methodist Church
National Association of State Universities and Land-Grant Colleges
National University Continuing Education Association

Mr. Chairman and Members of the Subcommittee on Taxation:

I am William Byron, President of the Catholic University of America. I appear today on behalf of the American Council on Education, an association representing over 1,700 colleges, universities, and other organizations in higher education, and the associations listed on the cover sheet of my testimony, to express the disappointment and concern of the higher education community at the expiration of section 127 of the Internal Revenue Code, the Employee Educational Assistance Act. It is our hope that the Congress can act at the earliest opportunity to reinstate this provision.

Section 127 was enacted to eliminate inequities and to remedy inefficiencies in programs of educational assistance for employees. Prior to 1978, an employee could claim a deduction for amounts expended for education only if the education related solely and directly to the employee's current job position. This limitation on deductibility of educational expenses severely limited the ability of lower-compensated employees to seek job advancement, and also limited the ability of an employer to promote the training and technological advancement of its work force.

With the full support of the higher education community, Congress acted in 1978 to provide a more even-handed and efficient incentive to employment-related education. Section 127 allows an exclusion from gross income for amounts paid by an employer, not including amounts paid in lieu of taxable compensation, for educational expenses of an employee whether or not related to the employee's current position. Because of a sunset provision in the 1978 legislation, and because of a dispute over imposing FICA and FUTA payments on such benefits, section 127 expired. I believe that the lapse of this provision was extremely unfortunate as a matter of social policy, and was wholly unnecessary as a matter of tax policy.

In hearings before this and other committees in April and November of 1983, experts and educators testified as to the importance of employer assistance for education in maintaining our national technological capacity, in retraining displaced workers, and in opening new employment opportunities to women and minorities. Statements submitted on behalf of businesses which have adopted educational assistance programs indicated that such programs are used in large part by lower-compensated employees, taking courses to prepare them for better jobs; that the programs play an important role in facilitating career advancement for minorities and women; and that employees would be much less likely to participate in educational assistance programs if additional amounts had to be withheld from wages.

Moreover, the many corporations and industry associations which supported an extension of section 127 emphasized, in addition to the significant societal benefit of the provision, a clear and direct business benefit. An officer of General Dynamics, for example, suggested that, "education and training is a critical work force function that is an absolute necessity to meet the rapidly changing and advancing technology of the modern world today. It is the only viable means to maintain a highly motivated and productive work force."

Section 127 is not in any strict sense a "fringe benefit," since educational assistance cannot be provided to employees in lieu of additional compensation. Section 127(b)(4) specifically provides that a qualified program must not allow employees a choice between educational assistance and remuneration includible in gross income. The prohibition on use of salary reduction plans under section 127 means that educational assistance programs are adopted by employers on the basis of a calculated judgment as to their own long-term business needs. Employer financing of educational assistance programs ensures that the programs maintain a primary business rather than compensatory focus. We do not seek any change in this aspect of section 127. The concern I am expressing today is with the extension, not with any expansion, of section 127.

The business-purpose orientation of employee educational assistance programs under section 127 is, I believe, a sufficient and satisfactory answer to the tax policy concerns that the Treasury has expressed in the past, and that members of this Subcommittee may feel. The distinction drawn, under the regulations implementing section 162, between education that is related to an employee's current job and education that allows job advancement grew out of the traditional view that expenditures for education are presumed to be personal in nature, and thus nondeductible, in the absence of a showing that the education is primarily business-related. The distinction between present jobs and potential jobs is simply a matter of administrative convenience, to eliminate the need to inquire in each case as to the specific motivation of the individual. I do not believe that the Treasury would argue that expenses for education actually related to job advancement are inherently less business-oriented than expenses for education to maintain a current job. The issue is only one of proof, and the current-job rule of section 162 is simply a way of drawing an enforceable line between personal and business expenses.

In programs established under section 127, this tax policy issue is adequately addressed. I believe that we can rely upon employers who are expending their own funds for educational assistance to maintain the appropriate business orientation, and to see that employees do not use the program to satisfy personal education objectives with tax-free funds. The protection against tax-favored treatment for personal consumption of education which is provided in section 162 by the present-job limitation is provided in section 127 by the requirement of employer funding.

Once the tax policy objectives of the Treasury are satisfied, we can evaluate section 127 on a value-for-money basis. I think that, so measured, the employee educational assistance program is among the best buys in the federal budget. The Treasury Office of Tax Analysis estimated last November that if section 127 were extended, the government might forego $25 million in revenues in 1984, and an average of $50 million a year in 1986-88. These figures represent the taxes that (in theory) would be paid by workers who were required to include in income amounts paid for education related to job advancement, assuming a marginal tax rate for such workers of less than 25%. Testimony at the 1983 hearings indicated that when educational assistance is taxable, employees, including those of colleges and universities, are much less likely to use the program. All of this means that any revenue foregone under section 127 serves as a real incentive to behavior which is valuable to business and important to the nation - an incentive that is significantly leveraged through employer funding.

The cost of section 127 is relatively slight, but the return both to employers and to society is substantial. Our national needs for employment, retraining, technological advances, and opportunities for the traditionally under-employed are so great that it seems short-sighted indeed to eliminate a program that in a few years has achieved significant demonstrable success.

Throughout 1983, with the sunset date of section 127 approaching, representatives of both industry and higher education attempted to convince the Treasury and the Congress of the need to preserve the provision. Although the legislative timetable was unsettled, there was evidence during 1983, and increased evidence in 1984, of strong support for employee educational assistance, and there was good reason to believe that action would be taken to extend, or during 1984 to reenact, section 127. On this basis, and recognizing the importance to both business and individuals of sustained and stable educational opportunities, many employers maintained established programs, and continued to treat educational assistance payments as amounts excluded from gross income.

In light of the legislative situation, this was a reasonable and responsible practice, and I believe that under the circumstances no penalties would be imposed under normal Internal Revenue Service practice with respect to either income tax or employment taxes which might be owing for periods after 1983. I also believe, however, that this should not be left for determination, with needless expenditures of effort and expense, in an individual audit context. If action on section 127 should for any reason not be retroactive to December 31, 1983, I would ask the Congress for an expression of its intent that no penalties be applicable with respect to the continuation of the tax treatment provided by section 127 during the period, I hope a short one, of its statutory lapse.

Faculty Housing

Recent tax legislation imposed a moratorium until the end of next year on the issuance of any rules or regulations providing for taxation of certain qualified faculty housing furnished in 1984 and 1985. At the same time, Congress failed to deal fairly with four New England schools which are vulnerable for past years. This subject should be resolved before the end of this Congress.

We believe that educational institutions should be able to provide cost-based faculty housing programs without tax consequences to them or their faculty and staff. It makes no sense for a faculty member to have to pay rent based on what a businessman in the community would have to pay for the same dwelling, when it is likely that the faculty member would otherwise be living in less expensive, more remote housing or, at least in the longer run, would prefer to be purchasing housing in order to take advantage of various interest and tax deductions. It makes no sense to view faculty housing programs as commercial operations, since they are maintained by nonprofit educational institutions for education-related objectives of promoting an integrated campus community. Finally, it makes no sense to use a fair market value standard for faculty housing, which would require annual appraisals and result in serious inequities, when Congress has opted for a cost-based approach where airline travel, employee discounts, and other fringe benefits are concerned.

The Congress cannot, moreover, allow four New England schools to be forced by the IRS to pay back taxes based on the difference between rents charged and the fair market value of their housing. By virtue of its enactment of the moratorium on taxing faculty housing, the Congress has implicitly but clearly determined that the law governing this area is at best unclear. These schools should not be forced to pay up or to litigate their claims where their interpretation of the relevant law was so plainly reasonable. Congress should thus act to make clear for the future a prospective rule for faculty housing programs, and to wipe the slate clear for the past.

Senator PACKWOOD. Here is a classic example of a service that the Government is going to provide, if it is not otherwise provided, assuming we were willing to appropriate the money at all to do it. We certainly have set one goal in this country; education. That goal is upgrading education for people who have suddenly run out of trainable jobs, and their skills need upgrading. I see no harm in encouraging businesses, universities, community colleges to participate in that in whatever fashion we can encourage them to participate.

Of all of the benefits, this is the one that hurts the most because it, I think, unfairly disappeared. Father, you have touched on it exactly in terms of retroactive tax status. We are now going to have unemployed workers who are being retrained, hopefully, for a job and they are going to have to pay taxes on the value of their training, and they are unemployed. It is simply unfair.

Dave?

Senator DURENBERGER. No questions.

Senator PACKWOOD. Jack, you came in next.

Senator DANFORTH. No questions.

Senator PACKWOOD. John.

Senator CHAFEE. No questions.

Senator PACKWOOD. I would touch on just one thing before you leave. Senator Chafee questioned if it is fair that you go to work for one company and it provides a certain level of health benefits or none, as the case may be, and the same thing can be said about any employment in general in this country. We are a diverse country. Indeed, we could have uniformity throughout this country if we wanted. We could say that every single employer must provide 1 week of vacation after a year of work and 2 weeks after 3 years, and 5 weeks after 10 years, if we want. But we don't. If you happen to go to work for an employer that provides only 3 weeks of vacation after 10 years and somebody else works for one that provides 5 weeks of vacation after 10 years, you have a variety of options. But we have never thought it was necessary Government policy that everyone's employment conditions—whether they be vacations or sick days—had to be absolutely equal. I think the system's diversity by and large has worked out pretty well.

Is it unequal? Of course. Diversity is unequal. But the choice is Government mandated uniformity. I'm not sure that is to be desired in education or employment.

Senator CHAFEE. Well, I don't think anybody is asking for uniformity in this country. That is un-American. That is bad business. We all know that. But it seems to me that not only is there currently existing unfairness but this Congress a couple of years ago made it even more unfair because the person who does not have his health and accident premiums paid for formerly, at least, could deduct a portion of the health insurance premiums he paid for himself. As I recall, you could deduct up to half of your premium. Now you can't even do that. We eliminated that benefit.

I think the only way you can deduct your premium now is as part of your general medical expenses. Thus unless you reach the threshold required percentage that you have to have in order to deduct your medical expenses, you can not deduct the health insurance premiums at all. Is that correct? I notice you are shaking your head. I always look for somebody who is shaking his head.

Senator PACKWOOD. John, I think you are roughly right. As I recall, it may have been a maximum deduction of $150. We did get rid of it 2 or 3 years ago.

Senator CHAFEE. It seems to me we have retreated from fairness. These hearings are to explore these matters and to try to learn more. I'm not saying that we should eliminate tax-free employer paid medical insurance. However, it does seem to me that there is a good deal of unfairness which was probably accentuated by what we did in 1981.

Thank you, Mr. Chairman.

Senator PACKWOOD. Gentlemen, thank you very much.

Father BYRON. Senator, thank you. And for the higher education community I thank you for your leadership in the area of employee educational assistance.

Senator PACKWOOD. Thank you, Father.

Senator PACKWOOD. Now we will take Henry Sharpe, Jr., the chairman of the board, Brown & Sharpe; Robert Ragland, the director of taxation for the National Association of Manufacturers; William Badgett, the director of benefits planning for Motorola; Ernest Reach, the manager of employee benefits, Sun Chemical; Warren Moser, division staff manager, benefit plans, Southwestern Bell; and George Perrin, the manager of benefits planning for Eastman Kodak.

Senator CHAFEE. Mr. Chairman, I just want to say how delighted we are to welcome Mr. Henry D. Sharpe, Jr. He has been president-chairman of one of the largest manufacturing companies in Rhode Island. He has done a wonderful job at that. He has been an outstanding citizen in our State in a host of ways. It's a great treat for me to introduce him. Furthermore, he's my cousin. [Laughter.]

Senator DANFORTH. I will make similar comments with respect to Mr. Moser except for the fact that he is not my cousin. [Laughter.]

Senator PACKWOOD. Mr. Sharpe, don't you have any more influence over your cousin than you do? [Laughter.]

STATEMENT OF HENRY D. SHARPE, JR., CHAIRMAN OF THE BOARD, BROWN & SHARPE MANUFACTURING CO., NORTH KINGSTOWN, RI

Mr. SHARPE. I take it that I am going to be called upon to answer Senator Danforth's question.

Senator PACKWOOD. Before we are done, yes.

Mr. SHARPE. I wish I knew the answer to that question. I am here today representing myself, my company, and the Rhode Island Business Group on Health, a recently formed association of employers in the State of Rhode Island who have a total now in Rhode Island of 28,000 employees and who nationally employ over 70,000.

And I come here today not an expert. Listening to the expert testimony that has been given on all sides here by people who really know their stuff in the world of benefits, I don't want to pose as the equal of any of these gentlemen.

I am here, however, schooled—as I have been in the last 5 or 10 years—by the hard knocks of foreign competition. American manufacturers are intensely under the gun today to inspect their effectiveness and efficiency in every aspect of their operations. Health care and related benefit costs, of course, have become a very important part of the American cost structure.

When I say a "very important part," we have to appreciate that benefit costs in the group that I represent range between 22 and 36 percent of all wage and salary compensation.

I am also impressed by the fact that the impact of any proposed changes in the benefit area will have a predominately larger effect on those of lower income than on those of higher income.

And third, I'm impressed by the fact that very constructive initiatives are being taken in our community today, not only to simply restrain health care costs, but to work closely with health care deliverers to enhance the effectiveness with which their services are delivered.

I cannot imagine moreover, to simplify a very complex equation, that a monolithic government plan, more closely administered than that we now have at the local level in America, could possibly be more effective even with the imperfections that we see today.

I subscribe to Senator Packwood's remarks about diversity. And I would be very careful in removing jack straws from among the interrelationships that have been established in this benefit area that you are now considering. I would be very careful, indeed, about anything resembling rapid or cataclysmic change.

Thank you for the opportunity to appear.

Senator PACKWOOD. Thank you, Mr. Sharpe.

[The prepared written statement of Mr. Sharpe follows:]

U.S. Senate Committee on Finance
Subcommittee on Taxation and Debt Management
Hearings on Fringe Benefits July 30, 1984
Written Testimony
of
Henry D. Sharpe Jr.
Chairman of the Board
Brown & Sharpe Manufacturing Company

On behalf of employers in Rhode Island, I wish to thank the Senate Finance Subcommittee on Taxation and Debt Management for the opportunity to present for the record our concerns regarding employee benefits. I speak to you today as a representative of the Rhode Island Business Group on Health, a coalition of 22 employers representing 28,000 Rhode Island workers, and over 70,000 employees nationwide.[1]

Congress has demonstrated the wisdom of encouraging the private sector to provide for the welfare of its employees through benefit programs tailored to their specific needs, during their active worklife and in their retirement. By encouraging this diversity, the health and retirement income needs of the workers of this country and their families are provided for without resorting to national health insurance or further diluting the Social Security program. This broad coverage of an estimated 150 million people should continue to be encouraged by the tax code. Should the tax incentive be dismantled by encroaching taxation, restriction or excessive paperwork, Congress would be left to meet these needs through direct expenditures on social welfare programs and retirement security.

I can demonstrate the breadth of this coverage using my own company as an example. Brown & Sharpe employs approximately 1,000 people in Rhode Island at this time. In 1983, we spent a little over 5 million dollars on employee benefits. This represents for us 23.5% of wages and salaries. This expense can hardly be called "fringe" benefits any longer, however we stand behind this investment in the welfare of our workforce as critical to the success of our business. Of this amount, over half provides payments for benefits required by law, social security, unemployment compensation and workers compensation. The remaining $2.2 million or 44% provides health coverage, dental insurance, life insurance and retirement security for our workforce. (See tables 1 & 2). I pose the question: could any federal government program provide for the health and income security needs of 1,000 Rhode Islanders for $2,237 each per year?

A few words need be presented on the effect of benefits across income levels, particularly tax favored employee benefits. Legally required benefits are paid generally as a percentage of payroll. So, too, would be pay for time not worked or other taxable benefits. The company's investment is made as a percentage of pay, and that percentage remains relatively uniform across pay scales. The tax free benefits tend in large part to be paid on a capitation basis. Premiums for health insurance are our largest single tax free expenditure. Because of the nature of health premiums, my company's investment in this program is about 7% of overall pay; but for a $10,000 per year employee it represents 15.5% of his pay, for a $20,000 salaried person, obviously half that. The tax favored health and welfare plans have the greatest compensation impact on the lower paid; they are a relatively insignificant portion of the total compensation of middle and upper management. And it has been demonstrated that 80% of those covered by employee health plans make less than $20,000 per year.[2] Consequently, any restriction or taxation of these sums would adversely effect the lowest end of the payscales.

The Rhode Island Business Group on Health was formed last year to assess what we could do to reduce health care costs. Employers generally have at least as great a stake as does Congress in containing the increasing cost of medical care for our employees. As a group, we find we are spending between 22% and 36% in addition to wages on benefits for our employees. A third of this investment is in legally required payments, another third or so is in taxable items. And we spend more than half of our employees tax advantaged compensation on health insurance. We are all interested in ways of holding this cost down. However, two very important points should be made about the current system. The first has already been demonstrated: we spend more proportional compensation on benefits for our lowest paid workers. However, we also deliver health coverage at a lower average cost in Rhode Island than we can in other parts of the country as measured by those of us who operate divisions elsewhere with substantially similar benefits. As a group we cover over 70,000 employees and beneficiaries with broad health coverage. And we are endeavoring to deliver quality coverage at efficient cost levels through our coalition efforts. It is in all of our best interests to vigorously pursue this cost factor.

In conclusion, my company and our associated companies in the Rhode Island Business Group on Health are investing large sums in our employees welfare through these programs. I doubt that any government program could provide as much at a similar cost, while respecting the diversity of employees needs. But if employer provided benefits are squeezed by additional taxation, legal restriction, or burdensome paperwork, the responsibility we have demonstrated will be discouraged. In the absence of these types of programs, our employees would look to government for medical aid, and we believe the price tag of a national health plan would be substantially greater to our nation.

I thank you for the opportunity to present my thoughts to you today and hope you will continue to encourage the dialogue between policy makers and employers on the subject of employee benefit tax policy.

-Notes-

[1]See Attached membership list.

[2]Employee Benefit Research Institute: Brief on Employee Benefits: Trends, Equity, and Federal Revenue Implications April 1984.

RHODE ISLAND BUSINESS GROUP ON HEALTH, INC.

CURRENT MEMBERSHIP

Company	BC/BS	Commercial/HMO		Total
A. T. Cross	1,200			1,200
AT&T	2,800			2,800
American Hoechst Corp.		Hancock	650	650
B.A. Ballou	443			443
B.I.F.	400			400
Brown & Sharpe	1,100	Travelers (MM)	1,100	1,100
Ciba-Geigy Corporation	200	Metropolitan	200	400
Davol, Inc.	400	Prudential	400	800
Electric Boat		Prudential	5,600	5,600
Federal Products Corp.	700			700
Fram Corporation	350	Travelers	800	1,150
GTE Sylvania	352	RIGHA	205	617
		Blackstone Valley Medical Group	60	
Hasbro Industries	1,441	RIGHA	26	1,593
		Ocean State	126	
Kenyon Piece & Dyeworks	460			460
Murdock Webbing	255	RIGHA	2	257
Narragansett Electric	1,000			1,000
Providence Journal	2,200			2,200
RI Builders Association	3,500	RIGHA	60	3,560
Textron	918	Aetna	2,137	3,055
Tupperware		Aetna	1,000	1,000
	17,719		12,366	28,985

/KLM
4-30-84

Company Name (Optional) Brown & Sharpe

[XX] All Employees # 1,000
[ ] Salaried Only #

TABLE 1

EMPLOYEE BENEFIT DOLLAR COST, BY CATEGORY, 1983

Benefit	Employer Payment $	Per Employee $
Total Benefits	5,114,000	5,114
Legally-Required Employer Payments	2,877,000	2,877
Social Security	1,464,000	1,464
Unemployment Compensation	313,000	313
Workers' Compensation	1,100,000	1,100
Other Payments		
Discretionary Taxable Benefits		
Time Not Worked		
Rest Periods		
Other Taxable Benefits		
Discretionary Tax-Favored Benefits	2,237,000	2,237
Defined Benefit Pension Plans		
Capital Accumulation Plans ESOP, Thrift	363,000	363
Disability Plans		
Group Health and Life Insurance	1,546,000	1,546
Active Workers		
Retirees		
Other Tax-Favored Benefits	328,000	328

Company Name (Optional) Brown & Sharpe

[XX] All Employees # 1,000
[ ] Salaried Only #

TABLE 2

EMPLOYEE BENEFITS PERCENTAGE COST, BY CATEGORY, 1983

Benefit	Employer Payments as Percent of Wages and Salaries	Employer Payments as Percent of all Benefits
Total Benefits	23.5%	100%
Legally-Required Employer Payments	13.2	56.3%
Social Security	6.7%	28.7%
Unemployment Compensation	1.4%	6.1%
Workers' Compensation	5.0%	21.5%
Other Payments		
Discretionary Taxable Benefits		
Time Not Worked		
Rest Periods		
Other Taxable Benefits		
Discretionary Tax-Favored Benefits	10.3%	43.7%
Defined Benefit Pension Plans		
Capital Accumulation Plans	1.7%	7.1%
Disability Plans		
Group Health and Life Insurance	6.4%	27.1%
Active Workers		
Retirees		
Other Tax-Favored Benefits	2.2%	9.5%

STATEMENT OF ROBERT A. RAGLAND, DIRECTOR OF TAXATION, THE NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Senator PACKWOOD. Mr. Ragland.

Mr. RAGLAND. Mr. Chairman, good morning. I'm Robert Ragland, Director of Taxation for the National Association of Manufacturers. With me today is Pat Callahan, NAM's director of employee benefits. On behalf of our member companies, we are pleased to present our comments on the tax treatment of fringe benefits. As the text of our comments will appear in the record of today's hearing, I will summarize my remarks at this time.

There are four points that I would like to make. First, we are concerned that Congress is looking to employee benefits for revenue necessary to reduce unacceptably high Federal deficits. We think that this is an unfortunate development. Expanding the tax base by taxing employee benefits will raise precious little new revenue at the expense of the network of sound public policy objectives embodied in our Tax Code. While we recognize that America has a great interest in a balanced Federal budget, we also recognize an equally legitimate interest in an educated, qualified, healthy and secure work force which has resulted from the current system.

Second, there has been enough change. After months of work, the Congress recently enacted a sweeping codification of so-called nonstatutory fringe benefits. Other changes occurred in 1981 and 1982. Certainly by now Congress has closed the most egregious areas of abuse. If so, I think we can all well benefit from a time of settling out.

Third, we do not believe that Congress can make the employee benefit system work better by withdrawing from the business Government partnership which has promoted a sound labor force in this country. Pursuant to Federal policy, the business community has provided a whole range of benefits which have become expected by employees. Fine tuning this program is not likely to produce acceptable results.

Fourth, and finally, as employees have come to expect a certain level of employee benefits we think that they will seek the status quo. We don't believe that the average employee can find equal benefit in the free market. Through collective bargaining and collective purchasing of benefits by employers, all have secured a broad range of benefits essentially available on a nondiscriminatory basis. And these have been provided cost effectively.

In closing, the NAM recommends that Congress continue to focus on ensuring the network of employee programs be available as widely as possible on a nondiscriminatory basis. This focus does not call for more reform in the tax treatment of fringe benefits.

Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you.

[The prepared written statements of Mr. Ragland, Mr. Huard follows:]

Statement

of the

National Association of Manufacturers

on

The Tax Treatment of Fringe Benefits

Before the

Subcommittee on

Taxation and Debt Management

of the

Senate Finance Committee

Presented By

Robert A. Ragland

Director of Taxation

July 30, 1984

I am Robert A. Ragland director of taxation for the National Association of Manufacturers (NAM).

NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Members range in size from the very large to over 9,000 small manufacturing firms, each with an employee base of less than 500. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufacturered goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here today to discuss the subject of the tax treatment of fringe benefits.

The National Association of Manufacturers would like to take this opportunity to commend the Subcommittee for scheduling these hearings. The tax treatment of employee welfare plans and fringe benefits is a matter of importance to those interested in a qualified and productive workforce and secure retirements, without undue reliance on Federal programs.

In its hearing notice, the Subcommittee asked for responses to a series of questions regarding the public policy aspects of Federal tax policy in the fringe benefits area. Before responding to those questions, the NAM would like to present some general observations.

In recent years, substantial changes in the tax treatment of employee benefits have been enacted. Over the past three years, Congress has been on a rampage seeking new revenues to close deficits. Rather than cut spending, taxes have been raised through a series of so-called "loophole" closers and "anti-abuse" devices. After the bright beginning of the Economic Recovery Tax Act of 1981 (ERTA), the President in 1982 signed the Tax Equity and Fiscal Responsibility Act (TEFRA) with congressional assurance that tax increases would be more than equaled by spending cuts. The promise, however, never materialized. Instead of a 3:1 ratio of spending cuts to tax increases, the country got more Federal spending. More recently, in July of this year, the President signed H.R. 4170, the Deficit

Reduction Act of 1984. As with TEFRA, at signing, the spending package was - and remains - in large part incomplete.

One victim of this tax and spend melee both in TEFRA and now, is employee benefit programs. For example, the recently-enacted employee benefit provisions of H.R. 4170 establish a series of administrative burdens and other policies which will only become more complex over time. Viewing these recent changes in conjunction with those made by TEFRA, it becomes apparent that Congress is moving toward enlarging the tax base by restricting or eliminating a broad range of so-called tax preference items. NAM believes this trend is damaging to the legitimate public policy objectives embodied in those items and to the overall network of our tax code.

For example, Congress has allowed the section 127 exclusion for tuition assistance to expire. The resulting Federal policy is that employees receiving educational assistance from their employers must include those payments in their income unless the course taken is job related and does not qualify the recipient for a new trade or business - a vague and restrictive standard. This result does little to help the displaced worker or to keep America's work force technically skilled.

The point is that each tax-advantaged employee benefit program represents an important public policy determination. Rather than scrap these incentives as loopholes in the name of revenue enhancement, NAM urges Congress first to exercise fiscal restraint -

through such mechanisms as the Balanced Budget Amendment - and then to the extent new revenue still is needed, to raise it through a transaction-based consumption tax, such as a value-added tax (VAT). In this regard, I have attached a copy of NAM's comments before the Treasury Department on the subject of tax reform.

We turn now to the specific questions presented in the hearing notice.

(1) Should the tax law encourage employers to provide fringe benefits; and if so, which benefits or services should be encouraged and what type and level of tax incentive is appropriate?

NAM believes that the tax law should encourage employers to provide broad based nondiscriminatory benefits. In our judgment, health, disability, life insurance, and pension programs are more cost effectively provided by the private sector than through Federal intervention. The current system, in our view, is complementary to other government sponsored programs such as Medicare/Medicaid and Social Security. Obviously any cut back will tend to shift the burden from the private sector to the public. This result should be avoided if at all possible.

(2) What conditions or restrictions are appropriate on tax incentives to encourage employers to provide fringe benefits?

Restrictions, by their very nature, discourage the offering of benefits. Some restrictions may be necessary to ensure that the benefits of tax-advantaged programs are broadly based and nondiscriminatory. It is equally necessary, however, to strike a balance between the government's wish to ensure wide distribution of benefits and the employer's desire to avoid unnecessary administrative costs.

An example can be found in Title V of the recently enacted Tax Reform Act of 1984 (one of two major divisions of the Deficit Reduction Act of 1984). In addressing subsidized eating facilities, Congress said that the value of subsidized meals provided by the employer in a dining facility is not includable in the employee's income if the facility is on or near the premises of the employer, the employer derives revenue sufficient to cover the direct costs of operation, and the facility is operated on a nondiscriminatory basis.

On its face these seem to be reasonable requirements, but in fact they will result in an administrative nightmare.

For example, to ensure wage parity, some companies pay food handlers on the same wage scale as manufacturing employees. This practice is not uncommon in union shops. To comply with the requirement that revenues equal direct costs employers will have to charge exorbitant rates or apportion the difference among all employees using the facility. The choices are three in number: (1) close the cafeteria; (2) realize revenue equal to direct cost; or (3) charge subsidized rates and apportion the shortfall as income to all employee users.

As most companies operating cafeterias do so for sound business reasons, the likely result will be cost apportionment with its attendant recordkeeping requirements.

(3) Are the existing rules concerning fringe benefits sufficient to ensure that all employees benefit fairly from the tax incentives?

We believe the current rules are more than adequate for this purpose. In our judgment the legislative changes of the past few years have resulted in extensive confusion, uncertainty and unpredictability. Some "settling time" would be highly beneficial. Further change, therefore, is warranted only to address the most egregious examples of abuse.

(4) Are the existing tax incentives for benefits such as health care, life insurance, day care, educational assistance, and cafeteria plans effective in encouraging employers to provide these benefits to a broad cross section of employees at a lower total cost than if the Government provided the benefits directly, if employers provided the benefits on a taxable basis, or employees purchased these benefits on their own?

We believe that the most cost effective method of providing any of these benefits is through the private sector. The Federal government has demonstrated no particular expertise in the management of existing social programs, and is not likely to improve its record soon. An expanded Federal role would not be supported by the NAM.

We also would not support a shift to employee purchased benefits. This change would result in either increased cost or diminished coverage, and is likelv to discriminate against the elderly. For example, employee purchased health care would:

o Result in Less Coverage at Higher Rates. By purchasing group coverage many NAM companies are able to average the cost of coverage over many persons. Those more prone to illness are subsidized by those not so likely to be ill. Moreover, the scope of these plans generally is broader, ensuring a healthy and productive work force. In addition, employer provided health plans - rather than Medicare - are now considered primary for workers 65 to 69 under regulations implementing TEFRA. Thus older workers are more reliant on private coverage - particularly where the employee group includes a significant number of older workers.

o Discourage the Use of Health Maintenance Organizations (HMOs). Because of their comprehensive benefit coverage, HMO premiums are often higher than health plans which cover fee-for-service care. HMO's, however, have provided cost savings through decreased hospitalization.

(5) <u>How will tax laws that encourage employers to provide fringe benefits affect compensation planning?</u>

Certain standards of employee welfare benefits are expected to be met by U.S. employers. These standards have resulted from collective bargaining agreements, Federal and State tax laws, and employee safety, health and development programs, and not primarily from a desire to put compensation on a non-cash basis. Therefore, maintenance of the existing system is not likely to affect compensation planning.

Conversely, if the government's support (through the tax laws) is withdrawn from the business-government partnership, it is the cost of expected benefits, not the standard, that likely will be shifted. As disposable income is reduced we expect collective bargaining agreements to be re-opened and salary negotiations generally to start at higher levels. Obviously, this will have an inflationary impact. The result, in some cases, will be higher product costs for the consumer both here and abroad, and in other cases, reduced levels of employment.

(6) Will tax incentives for employer-provided fringe benefits affect a potential employee's choice of employment?

Currently, we don't believe so. Statistics appear to show that job satisfaction for most employees is more important than benefits. How much this will change is not known. Our sense, however, is that most workers will continue to opt for satisfying and secure employment with the expectation that standard benefits will continue to be provided.

Summary

Additional changes in the tax treatment of employee welfare and fringe benefit programs is not now needed. Indeed, we believe that great benefits would result from an extended period of stability in this area. Assuming that the most egregious abuses were closed by TEFRA and the Tax Reform Act of 1984, we can see no reason to further change a body of law already encumbered by a tortuous maze of regulations.

Instead, we encourage Congress to focus on more pressing issues. Spending restraints, such as the Balanced Budget Amendment, need to be enacted. Federal programs need to be carefully reviewed and cut or eliminated to prevent duplication and unnecessary services. Finally, as a last resort, new revenues can be sought preferably through a transaction based consumption tax, such as a VAT.

In this way, any perceived need for new revenue can be met without compromising economic growth and stability through continued tinkering with the tax code.

STATEMENT OF

PAUL R. HUARD

ON BEHALF OF THE

NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE U.S. TREASURY DEPARTMENT

HEARINGS ON TAX REFORM

JUNE 26, 1984

I am Paul Huard, Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers (NAM).

NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Members range in size from the very large to over 9,000 small manufacturing firms, each with an employee base of less than 500. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufacturered goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here today to discuss the subject of comprehensive tax reform.

Discussion of Present System

Let me state at the outset that we applaud this effort by the Treasury Department, at the direction of President Reagan, to develop a comprehensive plan to reform our Federal tax system. In our view, the present system is both excessively complex and widely perceived as being unfair, a situation which undoubtedly has an adverse effect on compliance. More significant, however, is the excessive reliance of the current system on the taxation of individual and corporate income. At present, about 55 percent of the government's receipts are derived from income taxes. NAM believes this percentage is too high.

For decades, federal tax laws have tended to favor consumption at the expense of savings and investment. This is evident from the fact that income is taxed when it is earned, and then if it is saved the income on such income is also taxed. Another glaring example of the system's anti-investment bias is the double taxation of corporate earnings paid out as dividends. In such cases, the combined income taxes paid by the company and its shareholders on the company's earnings can rise to as much as 73 percent at the federal level alone.

We acknowledge that the tax system's tilt towards rewarding consumption at the expense of savings and investment was in part redressed by the capital formation incentives contained in the President's Economic Recovery Tax Act of 1981 (ERTA). However, we must also note regretfully that these incentives have already been substantially diluted as a result of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). NAM believes it is critical that we preserve important capital formation provisions such as the Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit (ITC) without any further erosion. These incentives are necessary to enable our members to increase their productivity and improve their international competitiveness, two factors which are essential for sustained economic growth and greater employment.

Indeed, a major drawback of the present tax system is its adverse effect upon our export competitiveness. Payroll taxes together with income taxes now account for over 90% of all federal budget receipts. A substantial portion of such taxes are reflected in the cost of U.S.-manufactured goods. Under the General Agreement on Tariffs and Trade (GATT), however, it is not possible to rebate, on items exported from the U.S., that portion of an item's cost that can be attributed to the income and payroll taxes paid by its manufacturer. On the other hand, many of our trading partners derive a much higher proportion of overall tax revenues than we do from transaction-based taxes such as the value-added tax (VAT) which, under the GATT, may be rebated on exports. The availability of such tax rebates to exporters in those countries puts U.S. exporters at a significant competitive disadvantage.

At present, the United States government derives well under 10 percent of its total budget receipts from transaction-based taxes that are rebatable on exports. We suggest that a substantial increase in this percentage would be warranted—in general for the purpose of improving the balance of a system that now rewards consumption and penalizes investment, and in particular to improve the export competitiveness of our manufacturing industries.

Tax Reform Alternatives and Timetable

We realize that the Treasury Department's mandate is to consider reform alternatives which raise approximately the same amount of tax revenue as the present system. In preparing this statement, nevertheless, we concluded that, with or without the Administration's active encouragement, Congress may in 1985 attempt to raise a substantial amount of new tax revenue as a means of reducing federal budget deficits. NAM believes, as does this Administration, that the primary strategy for lowering deficits must be reductions in the growth of federal spending. Nonetheless, it is possible that tax reform and meaningful expenditure reduction are likely to be forthcoming from the Congress only as a package.

We therefore have concluded, albeit regretfully, that the prudent course is to consider tax reform in the context of an attempt to increase federal revenues. In this regard, we think the following approaches are likely to be considered:

A. "Reform" of the system through numerous adjustments to the existing basic framework. This approach would merely repeat the technique used so successfully in TEFRA and the pending Tax Reform Act of 1984, where literally hundreds of changes modifying existing law were adopted.

B. Major overhaul of the existing tax system, involving a substantial broadening of the taxable income base together with a lowering of marginal tax rates. The base broadening could be achieved by either eliminating many existing deductions and credits, or expanding the definition of gross income to include items presently excluded, or both.

C. Enactment of a tax which is an "add-on" to the existing system and thus leaves that system intact. Surtaxes levied on the present income tax would be one approach; another would be imposition of a totally new tax such as a VAT or a national retail sales tax.

The first approach listed is clearly the least desirable. Bills like TEFRA and the pending Tax Reform Act of 1984 merely add further complications to a statute already overburdened with complexity. They are not based upon any discernible principles of sound tax policy. Rather, their primary motivation—and in our view quite possibly their sole justification—is purely and simply the raising of revenue to reduce deficits. At their best, such bills are patchwork repair jobs; at their worst, they are examples of political expediency.

Attempting a major overhaul of the existing system does have a great deal of appeal, particularly from the standpoint of simplicity. Any such overhaul, however, is likely to face enormous obstacles. In particular, efforts to broaden the taxable income base can be expected to give rise to substantial resistance on numerous fronts. All of the comprehensive base-broadening plans we have examined would require repeal of literally scores of exclusions, deductions and credits presently in the law. Each such provision has a constituency which could be expected to react vigorously in opposition to the proposed repeal. In some cases, for example with regard to capital formation incentives such as ACRS and the ITC, NAM would be among those resisting repeal.

Another problem is that wholesale repeal of existing law provisions is bound to be highly disruptive in that it will upset the financial assumptions underlying the long-term business and investment planning that goes on every day. Avoiding such disruption would at a minimum seem to require a relatively long transitional period for the phasing in of the new system. Finally, there is the issue of the length of time that would be required to achieve a massive restructuring of the current income tax law. We think it probable that some in Congress may want to increase tax revenues as part of the next Congressional budgeting cycle. If so, there obviously might not be enough time for adequate consideration of any major overhaul proposal.

In light of the foregoing considerations, the final generic approach that we mentioned—an "add-on" to the existing system—seems to have some promising features. An "add-on" tax that is simple and fair could be enacted in a much shorter time frame and with considerably less attendant controversy than could any major overhaul or restructuring proposal. Of the two "add-on" proposals most often mentioned—income tax surtaxes and transaction-based consumption taxes—it is clear to us that the latter are much to be preferred to the former.

Income tax surtaxes are simple, but they are hardly fair. Indeed, they would only serve to magnify existing differences amongst taxpayers, so that those already paying the highest effective rates would also pay relatively more in surtaxes. Moreover, such surtaxes would further exacerbate the already excessive reliance of the U.S. government on income taxation as the principal source of its revenues. For these reasons, NAM would strongly oppose the imposition of surtaxes on the existing income tax.

The various factors recited above, among others, have led NAM to conclude that a consumption-based tax would offer the best balance between the need to retain incentives for savings and investment and any perceived need for additional federal revenues. Revenues from such a tax could be used at least in part to replace revenues from the existing income tax system, thereby reducing its bias against savings and investment. Any revenues not so used should be applied exclusively to deficit reduction.

On this last point, we share the concern, expressed by many others, that consumption taxes are such powerful devices for raising revenue that their use might serve to fuel a resurgence in Congressional spending. We therefore would enthusiastically support statutory or constitutional limitations intended to preclude such a result. The possibilities include—but are not limited to—a balanced budget requirement, a limitation on spending as a percentage of the gross national product (GNP), a limitation on growth in tax revenues geared to GNP growth, or a dedication of all or a specified portion of the revenues from the new tax to deficit reduction.

Design of a Consumption-Based Tax

In designing a consumption-based tax, NAM believes the following factors should be taken into account:

Simplicity. The tax should be simple to understand and to administer. This factor would seem to point in favor of a transaction-based consumption tax, e.g., one imposed on an ad valorem basis when a taxable product or service changes hands. Indirect approaches to taxing consumption, for instance the so-called "consumed income" or "cash flow expenditure" types of taxes which, in effect, provide unlimited deductions for net savings and investment, are theoretically quite attractive. However, they would lead to an unprecedented increase in the recordkeeping required of individual taxpayers. Determining what is a deductible addition to savings and investment would raise many thorny definitional problems. (For example, is purchase of a personal residence consumption or investment?) Fairness clearly would appear to mandate extensive transitional rules for the treatment of amounts put into savings under existing law. Finally, the perception that only the wealthy can afford to save or invest would give rise to substantial political liabilities. Thus, while such indirect approaches would provide a desirable stimulus to capital formation, their practicality is doubtful.

Breadth. Obviously, the broader the base of the tax, the lower the rate that will be required to raise a specified amount of revenue. This is perhaps the most critical factor to be evaluated in determining the scope of any transaction-based tax. Among the questions to be considered and resolved are the coverage of the service sector and the point of collection of the tax. If the service sector is substantially omitted, the burden of the tax will tend to fall entirely on manufactured goods and a much higher rate will be required. A similar result will occur if the retail markup is omitted from the taxable base.

Fairness. In the case of transaction-based consumption taxes, an often-voiced concern is the potentially regressive impact of such taxes on lower income individuals. We believe, however, that any such impact can either be eliminated or at least satisfactorily mitigated by (a) low rating, zero rating or exempting certain necessities such as food and medicines, (b) providing income tax credits or increased personal exemptions and zero bracket amounts for such individuals, or (c) some combination of these techniques. Another fairness issue relates to the effect that imposition of a broad transaction-based consumption tax would have upon those sectors already burdened with excise taxes (e.g., alcohol, tobacco, fuels, tires, telephone service, etc.). It would seem appropriate to consider either repealing such taxes or at least reducing them by the amount of the new levy.

We hope that the foregoing suggestions are of assistance to the Treasury Department in its study of tax reform alternatives. On the specific subject of consumption-based taxation, we have included as an appendix hereto a more detailed discussion of the economic implications of consumption taxation, including an analysis of the European experience with VAT. I will be pleased at this time to address any questions you may have.

APPENDIX

SUMMARY OF THE ECONOMIC IMPLICATIONS OF CONSUMPTION TAXES AND THE EXPERIENCE OF WESTERN EUROPE

Prepared by Dr. Gordon Richards
Director of Economic Analysis
Taxation and Fiscal Policy Department
National Association of Manufacturers

I. ECONOMIC IMPLICATIONS OF CONSUMPTION TAXES

There has been comparatively less research done on the economic effects of consumption taxes than other tax provisions in the United States, in part because of lack of available data for the country as a whole. However, based in part on the experience in other countries and theoretical studies, it is possible to delineate several major effects.

1. Distributional Effects. One of the most pervasive (if not altogether justified) arguments that has been alleged against consummption taxes has to do with possible regressivity. This, however, is applicable mainly in the event that the tax is levied equally across sectors. The regressivity problem could be alleviated through differential rates on goods typically consumed by upper income brackets, or by lower rates on basic necessities, or by offsetting adjustments to the income tax. Although the relative tax shares of income brackets would probably be affected by consumption taxes, it is somewhat less clear that they would substantially shift the aggregate distribution of

income. In econometric tests gauging the impact of a VAT, consumption taxes are invariably found to be regressive, but when differential rates are used, they do not always have a pronounced impact on income distribution.

2. Effects on Prices. The proximate effect of consumption taxes is an increase in the price level. In theory, this should be a one-time-only outcome, since prices are marked up over tax costs but otherwise left unchanged. In practice, the situation may be more complex. Labor unions, confronting a decline in the real purchasing power of their members, may attempt to compensate for this by raising wages, setting a cost-push mechanism in motion.

The likelihood of "tax-shift inflation" taking place is undoubtedly greater in an environment characterized by loose monetary rather than by restrictive demand management policies. If the increase in the price level is not accommodated, real money balances (the nominal money supply less prices) will fall, leading to greater slack in the economy; hence, wage increases are unlikely. If on the other hand the consumption tax is accompanied by a one-time-only jump in the money supply, higher inflation will result only if wages are increased in response and monetary policy also accommodates the wage increases; if the subsequent wage increases are not accommodated, the effects on prices will be transitory.

3. Effects on Demand and Output. In the near term, consumption taxes induce a fall in demand, both because real money balances will decline and because the tax induces a shift from consumption to saving. The economy

therefore slows down under the impact of the decline in spending; the magnitude of the slowdown depends on the magnitude of the tax increase. However, interest rates also decline, primarily because of the weakness in credit demand associated with slower growth, but also because the Federal deficit declines, mitigating the "crowding out" process in credit markets, and higher saving raises aggregate liquidity. The decline in interest rates, possibly in conjunction with an easing of monetary policy, will provide greater stimulus to the economy, leading to higher growth. In the long-term therefore, the negative effects of consumption taxes on demand and output are likely to be transitory, while the positive effects are likely to predominate.

4. Effects on Investment. One of the strongest arguments in favor of consumption taxes is that they will tend to shift the mix of output toward greater capital formation. By taxing consumption, the taxes would induce consumers to invest more of their current income in financial assets, thereby raising aggregate liquidity and lowering the user cost of capital. This effect would be particularly marked in the event that the tax exempted (or gave a preferential rate to) spending on capital equipment.

5. Effects on Trade. Because of their effect on the relative prices of imports and exports, consumption taxes would tend to lower trade deficits. The price of imports would be raised, while the price of exports would be unaffected, since the tax would not apply to goods sold abroad. In essence, consumption taxes operate as a *de facto* tariff in terms of their effect on trade. This would raise real output in the short term, since imports would

decline, leading to a rise in the net export (exports less imports) component of GNP. The only scenario in which this would not occur would be if domestic prices rose sufficiently to outweigh the relative price change in traded goods.

6. Effects on Federal Revenue and the Deficit. Increases in consumption taxes probably represent a more effective way of reducing the deficit than other types of revenue increases such as income taxes, tax surcharges, etc. Consumption taxes, in addition to their direct revenue effect, also reduce the debt service costs of the Federal government by raising savings, as noted above. Conversely, income taxes do not have this effect, since taxpayers can react to the drop in income by drawing down their savings.

II. THE EXPERIENCE OF WESTERN EUROPE

In order to gauge the possible implications of consumption taxes, it may be worthwhile to overview the effects of such taxes in major West European countries, where they have been used extensively. Consumption taxes in Europe have generally consisted of Value-Added Taxes (VAT) levied at each stage of production. The VAT is levied on a sum equal to total value added (the difference between the value of a firm's sales and the value of material inputs to production) less purchases of capital equipment. While a VAT on gross income, *i.e.*, one which disallows deductions for investment and depreciation would theoretically be possible, in practice the industrial countries using VATs have not made use of this option. The VAT is typically not levied at a uniform rate on all sectors, but rather is applied at differential rates across industrial categories. The only major exceptions have been Denmark, which has consistently levied a single-rate VAT, and the United Kingdom, where a uniform rate was established in 1979. In Sweden, which nominally has a single rate VAT, the effective rate nevertheless varies across sectoral lines since only a fraction of value added is subject to taxation for some categories of goods.

France In France, the VAT has been in effect for over three decades and represents the major form of taxation used in this country. The VAT accounts for 48% of the revenues of the central government, followed by 20% for personal taxes, 10% for corporate income taxes and 8% for the excise tax on energy. The differential rates of the VAT have been explicitly designed to mitigate the regressive impact of consumption taxes, and to change relative prices in order to support the government's industrial policy, which has been aimed at channeling resources into heavy industry and capital investment: a zero rate applies to exports, a reduced rate to business equipment, and an increased rate to luxuries. Despite the differential rates, the effect of the VAT has been to make the tax system substantially more regressive and partially offset the impact of progressive personal income tax schedules. The distribution of overall tax liabilities by income bracket is roughly U-shaped, declining at the middle income levels, but rising at the upper and lower ends of the income scale.

The major economic effect of the VAT has been to shift spending into durable goods and industrial equipment, and away from the light industries and luxury products. Because of the zero rate on exports, the VAT has tended to support the French balance of trade, and econometric simulations suggest that reductions in the VAT are likely to be associated with external disequilibrium. Because of the distinctive feature of the VAT in France, however, in particular its use as part of a concerted industrial policy, its relevance to the United States is somewhat limited.

Italy In Italy, the VAT represents a more recent innovation, having been initially adopted in 1973. Its introduction was delayed in part by the existence of any number of prior retail and excise taxes which the VAT replaced. Differential rates have been used both to support macroeconomic objectives and to offset the possible regressivity of the VAT. Currently, it is levied at five rates ranging from 2% to 35%, with most categories taxed at 15%. A zero rate, however, applies to exports and some domestic activities that are likely to result in greater export activity. Because of the differential rate system and special treatment accorded to certain categories of agriculture and small business, there have been substantial administrative problems associated with VAT. Not only are the costs of administration relatively high, but the failure to enforce record-keeping and the special treatment of accounting for small business has led to widespread evasion. It is estimated that VAT receipts have been reduced by 30% to 40% because of systematic evasion or inadequate accounting procedures by smaller enterprises. Conversely, in the parastate sector (nationalized or semi-public corporations) and in large manufacturing enterprises, evasion is estimated to be much smaller.

In terms of its economic effects, the VAT has been linked in some studies with the acceleration in inflation during the early 1970s, on the grounds that wages were raised in an effort to compensate for the increase in retail prices. However, the contribution of the VAT to the inflation rate in general appears to have been negligible, and in this respect it is significant that the rise in inflation in 1971-73 anteceded the implementation of the VAT. The other effects appear to have been more favorable. The relative price of exports and certain inputs to manufacturing declined, resulting in higher growth in these sectors and a better external trade performance. The VAT also tended to raise investment, since capital spending was now exempted from taxation, whereas it had previously been subject to a levy. The effects on the distributuion of income do not appear to have been particularly pronounced. Because of the differential rate structure, the VAT did not appreciably reduce the progressivity of the tax system.

United Kingdom The VAT in the United Kingdom also dates from 1973, and was adopted specifically in order to gain entrance to the European Economic Community. It incorporates several distinctive features, among them the relatively large number of sectors other than exports that are wholly exempted. To a large degree, this was due to the aim of replicating the pre-existing sales tax system as closely as possible under the VAT. Further, the rates have been changed on several occasions. Originally, the VAT consisted of a standard rate and several higher rates. In 1979, however, this was changed to a single rate of 15%; this was motivated less by equity or progressivity considerations as by the need to raise revenues, following the

Thatcher government's reductions in income tax rates.

Because the VAT yielded tax rates that were not dissimilar from those previously in effect, its economic impact is not thought to have been particularly pronounced. As in Italy, the VAT was blamed in some circles for accelerating the price rise in 1973-74. However, in view of the other factors affecting inflation at this time, in particular the OPEC crisis and the wage-price rebound following the breakdown of the Heath government's controls, the effect of the VAT on inflation was minor. The VAT, in conjunction with accelerated depreciation allowances which permit first year expensing of capital equipment, substantially raised the rate of return on investment. While the ability of the VAT to boost investment spending has been the object of some debate in Britain, the generally lower ratio of investment to GDP in this country does not reflect any failure on the part of the VAT, but rather is attributable to other economic factors. If anything the VAT appears to have partially offset factors such as high rates of wage increase and high interest rates which worked against capital formation. On the other hand, the VAT is actually more neutral toward capital formation in certain sectors than the preceding selective employment tax, which generally worked in favor of greater capital intensity. The VAT did not raise British exports as much as in other European countries primarily because the pound was allowed to float, while the other European currencies were pegged under the EMS system. Nevertheless, it did change relative prices in favor of greater export activity. A further distinctive feature of the VAT in Britain is that it is not estimated to have reduced the progressivity of the tax system, although this was achieved only through the inclusion of numerous exemptions.

West Germany In West Germany, the VAT was adopted in 1965, although a general transactions tax had been in force prior to this time. The VAT is levied at a normal rate which has fluctuated between 10% and 13%, and a preferential rate set at one half the normal rate. Exports are wholly exempted, and any number of other exemptions are allowed in health, education and other social services. In contrast to France, where the VAT has been used in support of industrial policy goals, in Germany the use of preferential rates and exemptions has been aimed more at social welfare goals. Also, in contrast to Italy, the system of administration has militated against evasion, with the result that German authorities can point to almost universal compliance.

The economic effects of the VAT are generally adjudged to have been favorable. The German economy achieved high rates of growth in exports and investment during the period in which the VAT was in effect, although other factors contributed to this. The VAT did, however, shift the allocation of income between savings and consumption; in this respect, it is generally credited with increasing the savings rate and raising the liquidity ratio of the German economy. There is considerable evidence to indicate that the VAT had no effect on inflation. Despite the one-time increase in retail prices, the government secured an agreement for wage restraint by the major unions, with the result that the VAT-induced price increases were not transmitted to unit labor costs. The result was that in 1966-67 after the VAT was adopted, the rate of inflation actually declined. Various estimates have been made as to the effects of the VAT on the distribution of income. While the government estimated that the VAT was essentially neutral, some private sector studies claimed to have found an increased regressivity in tax burdens. Nevertheless, if the progressivity of the tax code was affected, the magnitude by which this took place was exceedingly small.

<u>The Netherlands</u> In the Netherlands, the VAT was phased in during the late 1960s as part of a general overhaul of the tax code; it replaced a complex series of consumption taxes, and is widely credited with having achieved a major simplification of the tax structure. A relatively large share of social services, including health, rents and insurance have been wholly exempted. Most exports are also zero rated, due to the substantial share (roughly half) of aggregate economic activity comprised by exports. A preferential VAT of 4% is levied on basic necessities, while other categories are taxed at 18%. The VAT in the Netherlands has been considered to be more neutral with respect to specific industries than comparable taxes in other countries.

In terms of its economic effects, the VAT has tended to raise exports. For this and for other reasons, the Netherlands has enjoyed large trade surpluses during the period in which the VAT has been in effect. If anything, policy makers have had reason to believe that the combination of the zero rating on exports and the normal VAT on most imports (except imported inputs to exporting industries) has on occasion put too much upward pressure on the exchange rate. Studies of compliance in the Netherlands have concluded that evasion has resulted mainly from administrative complexity and difficulties in record-keeping. Non-compliance was estimated in 1976-77 as amounting to only 1% of total revenues, however, a lower figure than in much of Western Europe. The effects on the distribution of income are considered to have been minimal. Although the VAT has not been neutral, as its framers originally claimed, its regressivity has been offset by other policies, with the result that the Netherlands has maintained one of the most egalitarian distributions of income in the world. The VAT is estimated to have engendered a one-time increase in the price level of approximately 3%, although this figure cannot be regarded as fully reliable inasmuch as the period during which the VAT was introduced coincided with a major jump in wages following the liberalization of wage controls. By the early 1970s, however, whatever impact the VAT may have had on inflation had been offset by a combination of wage restraints and more restrictive macroeconomic policies, with the result that the Netherlands has been able to hold its inflation rate below the European average.

Implications of European Experience The experience with the VAT in Western Europe has a series of implications vis-a-vis the use of consumption taxes in the United States.

1. The VAT has generally been subject to less resistance than personal income taxes. Compliance rates have normally tended to be higher, notwithstanding the experience of countries like Italy where evasion has been facilitated by inadequate administrative procedures. The greater compliance with the VAT and the comparative absence of widespread resistance stems in part from its lower "visibility", *i.e.*, the fact that it is collected on the basis of sales rather than income.

2. The VAT should not be viewed as inherently inflationary, despite the one-time increase in consumer prices. Instead, if consumption taxes are accompanied either by wage restraint or by non-accommodative monetary

policies, there is no lasting impact on inflation. Moreover, studies which have purported to find a relationship between the VAT and inflation have frequently failed to differentiate the impact of the tax from other factors. In the United States, the current high level of unemployment and other factors working against inflation make it highly unlikely that consumption taxes would have any significant effect on the rate of inflation.

3. By changing relative prices, however, the VAT has tended to produce a more favorable tax treatment of investment and exports. Further, the VAT has frequently generated an increase in the savings rate.

4. The regressivity problem is not necessarily a serious one. The use of differential rates and the exemption of basic necessities has meant that the VAT has not resulted in a significantly more regressive distribution of income or of tax liabilities.

STATEMENT OF WILLIAM F. BADGETT, DIRECTOR, BENEFITS PLANNING AND DEVELOPMENT, MOTOROLA, INC., SCHAUMBURG, IL

Senator PACKWOOD. Mr. Badgett.

Mr. BADGETT. Thank you for this opportunity to represent our 60,000 employees in the United States and their thousands of family members of Motorola throughout the 50 States.

Today I would like to share with you the legitimate concerns we and our employees feel when we hear about and read about efforts in Washington to take away or reduce present tax advantages of benefit programs. The particular plans we are concerned about and which will cover today are insurance, welfare types of plans, and our retirement income security plan, the types of our benefit plans which have tax favored treatment. These plans cover all of our employees, both hourly and salaried, both lower paid and highly paid. And they meet the common financial or security types of needs that all of us need whether we work for a business firm, Government or any other type of organization.

Those forms of protection, of course, are the sickness and injury protection, disability, death and the provision of retirement income. These plans we maintain are reasonable in cost and they do not favor highly compensated employees. In fact, the plans and their sources of tax advantages are at least as important to lower paid people as they are to the highly compensated.

As an example, in Motorola's actual experience, in 1983 our costs for employees were as follows: An employee earning $10,000, these benefits cost 19.1 percent of pay. For the $20,000 employee, the cost was 15.1 percent of pay. For the $50,000 employee, the cost was 11.5 percent of pay. Above $50,000, the percentage continued to decline.

These are benefits employees need. If Motorola had no corporate income tax deduction for them, it is highly unlikely we could afford them and still remain competitive in the worldwide markets in which we operate. If the employees do not receive reasonable income tax treatment, we do not believe they would be willing or possibly even able to afford to continue the plan.

If employees do not maintain these plans, many of our major national interests and goals would be adversely affected. The Federal tax problems, of course, could be great if Government replaces these benefits. As mentioned earlier, the major source of capital formation would be lost if there were no pension profit sharing savings for employee stock ownership plans.

Also, if the profit sharing or stock ownership plans disappeared, we would lose an important incentive to achieve productivity gains.

The private benefit system, in short, is not a tax give away program for the rich. Rather it is a successful, proven system that contributes to the best interest of millions of employees who participate in the plan, and the companies which provide them and the Nation as a whole.

To continue the success, we must look for two ways Congress can help us. First, consider carefully and in depth any change. Do not make changes early to correct perceived abuses, but only real abuses. And limit the corrections to the abuses themselves.

Second, please avoid frequent changes and sunset provisions. Benefit changes are very difficult, costly and time consuming. The cost of the number of employees we have and the geographical spread, we find it takes from 1 to 3 years for employees to really fully understand any benefits change we make in our program.

This hearing is an excellent step, we think, for greater mutual understanding. We hope that we will be able to participate in the future as you go through your process of determining and deciding legislation for the benefits area.

Thank you.

[The prepared written statement of Mr. Badgett follows:]

PRESENTATION

TO

SENATE FINANCE SUB-COMMITTEE ON

TAXATION AND DEBT MANAGEMENT

HEARING ON FRINGE BENEFITS

July 26, 27 & 30 1984

By

MOTOROLA, INC.

WILLIAM F. BADGETT
DIRECTOR OF BENEFITS PLANNING AND DEVELOPMENT

Motorola Inc., is a world wide manufacturing company in the electronics and communications industries with corporate offices in Schaumburg, Illinois.

Our United States manufacturing facilities are located in Alabama, Arizona, California, Florida, Illinois, Iowa, Massachusetts, Missouri, New Mexico, New York and Texas. Additionally, we have sales and service locations in all 50 states.

Today I have three objectives. First, I want to establish the value of employee benefits to employer organizations and all of their employees, not as tax savings or tax avoidance schemes, but as sound, reasonable financial protection and security plans. To do this I will describe, briefly, Motorola's benefits program for its United States employees. Although our benefits program is not the same as programs of other employer organizations, our concepts and concerns for our programs are similar.

Second, I will describe why our objectives for our benefits program are compatible with and contribute to national objectives.

Third, and finally, I will indicate why reasonable and dependable tax treatment is essential if we are to meet our objectives, and, thus to contribute to important national economic and social goals.

Motorola maintains four separate benefits programs. Three of them cover approximately 8,000 U.S. employees who are in three separate subsidiaries. The fourth program, identified as our Motorola Benefits Program, covers our other 52,000 U.S. employees. All four programs have similar types of benefits, similar purposes and similar levels of value to employees.

The remainder of today's presentation covers the Motorola Benefits Program covering 52,000 employees plus their family members.

The only major benefits not covered in this presentation are time-off with pay benefits...holidays, vacations, breaks, etc.

PURPOSES OF BENEFITS PROGRAMS

Motorola uses the following criteria for making decisions concerning the designs of our total benefits program and the individual benefits plans which form the total program:

1. Do the benefits meet the financial protection and security needs of our employees?

2. Can Motorola provide the means to meet those needs more economically, efficiently and with a higher degree of certainty than the individual employee can outside of a plan sponsored by Motorola?

3. Do the benefits contribute toward fulfilling Motorola's corporate obligations to its employees and the communities within which we operate?

4. Do the benefits contribute to such corporate objectives as quality of products and services, improved productivity and good employee relations?

5. Can Motorola provide a means for an employee to economically and effectively use his or her own funds to meet financial needs or to supplement Motorola's program.

6. Can Motorola administer and communicate the program effectively and develop employee understanding of the plans?

7. Are the costs reasonable in relation to the value of the benefits provided?

8. Can Motorola afford the costs of the benefits, both at the present time and under adverse economic conditions which might occur in the future?

We believe our benefits programs meet these criteria.

MOTOROLA'S SPECIFIC BENEFITS PLANS

Our Motorola benefits program is designed to meet the following four basic needs of our employees:

1. Protection for our employee and his or her family against the potentially catastrophic costs of illnesses and injuries.

2. Protection for our employee and his or her family against loss of income.

3. Protection for our employee's family against the financial consequences of untimely death.

4. Provide an adequate level of retirement income to permit a reasonable standard of living following retirement from Motorola.

These are basic needs which exist for employees of all organizations and are recognized by our Social Security System and benefits programs of most local, state and governmental organizations.

Employees today expect a reasonable benefits program. An organization without such a program will have difficulty in attracting and retaining competent employees at all salary levels.

Additionally, some benefits can meet dual objectives of financial security and enhancement of business objectives. Profit Sharing Plans and Employee Stock Ownership Plans can accomplish this.

Further, some benefits can contribute to national goals unrelated to benefits, such as savings and capital formation. Qualified Pension, Profit Sharing and Employee Stock Ownership Plans can accomplish this.

In order to provide financial protection and security in each of the four areas, Motorola maintains the following benefits plans.

1. Protection against expenses of health care.

   Three plans provide protection in this area.

   Our Medical Plan covers 80% of the costs of most medical expenses after an employee's or dependent's medical expenses exceed an annual individual deductible amount of $300 or a family deductible of $500. If an employee's share of the expenses for his or her family exceed $2,500 plus the deductible amount, the Medical Plan pays 100% of the expenses.

   Each employee pays a portion of the cost of the medical and dental plans.

   Our dental plan pays 100% of the expenses for preventative dental care. After an annual individual deductible of $100 or family deductible of $300, the plan pays 80% of other dental expenses, suject to maximum annual amounts.

   Our third plan is a health expense reimbursement account. Under this plan, Motorola deposits $46 per month which the employee may use to pay health care expenses not covered by the medical and dental plans. This plan was established on January 1, 1984. The funding of the $46 per month deposits was provided through savings from benefits reductions in our medical and dental plans.

2. Protection against loss of income.

   Our short term and long term disability plans provide this protection from the date of disability to age 65, or in some cases as long as age 70. During the first three months of disability an employee would receive from 75% to 100% of his or her salary.

   After the first three months, the benefit is 60% of salary.

   There is no cost to the employee for these disability benefits.

   Our Pension Plan provides lifetime income after long term disability payments cease.

   Our Profit Sharing and Employee Stock Ownership Plans provide additional funds for the disabled employee.

3. Protection Against Untimely Death

   All employees are provided group term life insurance equal to the employee's salary at no cost to the employee.

   An employee may purchase additional group term life insurance equal to one or two times salary.

   An employee also may purchase modest amounts of group term life insurance for his or her dependents.

Motorola provides additional accidental death and dismemberment insurance and travel accident insurance at no cost to the employee.

The Profit Sharing Plan provides additional funds. If the employee is over 55 and had 10 or more years of service, the Pension Plan will provide modest annual income to a surviving spouse.

4. Adequate Retirement Income

Motorola's major retirement income security is provided by our Profit Sharing Plan, which has been in existence since 1947. Motorola's annual contribution, which has averaged about 5% of salaries over the past five years, is based on a specific formula. The range of the contribution over those five years was from less than 2% to slightly over 6% of salaries.

Our Profit Sharing Plan permits employees to contribute up to 12% of salary on a "before tax" basis under the provisions of Section 401(K) of the Internal Revenue Service Code.

Our Pension Plan, when combined with Social Security, provides a modest level of retirement income for most employees. The levels for long service employees retiring at age 65 would range from about 50% to 70% of salary for lower paid employees down to about 35% to 45% for higher paid employees. Motorola pays the full cost of the Pension Plan.

Our final element in this area is our Employee Stock Ownership Plan under which Motorola contributes one half of one percent of each employee's compensation. The contributions are used to purchase Motorola Common Stock for each employee.

To provide an insight into the distribution of benefits costs among various salary levels, Motorola's 1983 costs for those benefits described were:

Salary Level	Motorola's Cost of Benefits as Percentage of Salary
$ 10,000	19.1%
20,000	15.1
30,000	12.4
40,000	12.2
50,000	11.5
Over $50,000	Less than 11.5

These are our major benefits programs. Some important comments on them are:

1. These plans cover all Motorola employees regardless of pay level or whether they are hourly paid or salaried employees.

2. All of the plans have maximum limitations which affect highly paid employees. Some of the limitations are required because of Federal laws, and some were selected by Motorola.

3. The levels of benefits are reasonable, and none of the costs are excessive.

4. In appropriate plans the benefits are designed to recognize and coordinate with legally required benefits such as Social Security and Workers Compensation.

5. All of the benefits have some form of tax advantage for employees, Motorola or both.

6. Most of the benefits can be maintained for a period of time by employees who are placed on lay-offs or leaves of absence.

7. The benefits are at least as important to lower paid employees as they are to higher paid employees.

I have not attempted to describe all of the details of our various plans. However, the description fairly and accurately reflects the values of the plans.

Our benefits program has evolved over many years in response to changing and emerging employee needs. In a continuation of this gradual, evolutionary process we plan to add a higher degree of flexibility to our benefits program. Changing lifestyles and demographics have made it difficult to design plans meeting the requirements of employees with diverse needs. Thus, our thrust for the near future is to give employees more individual choices on how benefits dollars are spent for them personally.

GOVERNMENT POLICIES ON BENEFITS

We believe most working people in the United States expect large employers to provide reasonable benefits for them in addition to benefits provided by governmental plans.

Therefore, if large employers do not provide those benefits, most working people will expect the Federal government to provide them. If this occurs, substantial tax increases will be necessary. Further, national benefits plans would not respond as effectively and economically to changing employee needs as would plans of individual employers.

A special problem for all of us today is the rapid rise in health care expenses. Employers, including Motorola, and providers of health care services have recognized this problem and the need to correct it. Many steps have been taken in response to the cost problem, and some favorable results have occurred. Employers have reduced medical benefits, initiated wellness programs and implemented employee educational and informational programs, all designed to make employees informed and concerned purchasers of health care services...a market oriented approach. And employers are beginning to manage their health care expenses, applying business principles to health care activities. We have done these things at Motorola.

Health care providers have responded with new and more effective ways to deliver their services. And they are better managing their own costs.

We strongly believe Motorola and other large companies are acting responsibly and effectively in the benefits area. But we need the understanding and cooperation of Congress to continue to do so.

Employee benefits are subject to complex federal tax laws and regulations. Employers accept these complexities and design their programs to comply with them because of the importance of favorable tax treatment.

If the tax treatment for both employer and employee did not provide reasonably advantageous treatment, it is unlikely the benefits would be continued. If business employers could not receive tax deductions for the costs of these benefits, few businesses could provide the programs and still remain competitive in today's world of international trade.

If employees were taxed immediately on their benefits, there would be little sense in having plans designed to provide retirement income, and very few employees would be willing to contribute from their own pay. Various types of company sponsored insurance or welfare plans would be less attractive and much less likely to be maintained.

In other words, without reasonable tax treatment most U.S. citizens would end up with only Social Security and other government plans at retirement placing even more pressure on federal taxes for these programs.

In addition to reasonable tax treatment, consistent and dependable tax treatment is essential. Frequent changes in tax laws applying to benefits, such as we have experienced over the past 10 years, create substantial additional administrative costs and cause confusion and serious misunderstanding for employees.

At Motorola, and I am sure other large companies face the same problem, it is very difficult to communicate changes, even simple ones, in benefits plans. Our facilities range in size from a few large manufacturing plants with 1,000 to 5,000 employees to small sales and service offices with 3 to 10 employees located in all 50 states. Any benefits change requires a major communication effort to reach all of them. Even then, it usually takes one to three years before changes are fully understood.

In summary, we and our employees need the present tax treatment, and we believe present tax laws adequately prevent excesses and abuses in the benefits area. Frequent changes are unnecessary and should be avoided. The Internal Revenue Code is complex and many of the Sections dealing with benefits plans are inter-related. A change in one Section can cause unanticipated results and complications in another Section. Therefore, we make two recommendations:

1. Develop a thorough understanding of the effects on benefits programs before changing tax laws or imposing additional rules on benefits plans. Be certain that broad tax abuses exist before passing laws to correct them. If abuses exist, write the law so as to correct the abuse without adversely affecting benefits programs which are valuable to millions of people and which contribute to national objectives. Recognize that favorable tax treatment may serve important purposes. Make certain additional rules accomplish worthwhile purposes.

2. Do not make frequent changes in laws affecting benefits, and use sunset provisions only when absolutely necessary.

We recognize that what we ask is difficult and could be time-consuming. But we urge Congress to hold open and frank discussions in special hearings before considering benefits legislation. Allow employers and other informed individuals and organizations to participate in your consideration with adequate time to achieve real understanding.

This series of hearings is an excellent step in the right direction, and we appreciate the opportunity you have given us to be heard.

Motorola would be pleased to participate in the process in any way we can contribute.

Thank you for the opportunity to share our concerns with you.

STATEMENT OF ERNEST J. REACH, MANAGER OF EMPLOYEE BENEFITS, SUN CHEMICAL CORP., FORT LEE, NJ

Mr. REACH. Good afternoon. My name is Ernie Reach. I'm the employee benefit manager of Sun Chemical Corp. in Fort Lee, NJ. I have been actively employed in the development and the administration of employee benefits programs more than 28 years. I have worked for insurance companies, consultants, and for manufacturing employers.

The Sun Chemical Corp. itself is a diversified manufacturer of chemicals and equipment. Principally, the equipment is for the graphic arts industry but also in support of the defense establishment. We have close to 5,500 employees domestically, located at approximately 50 locations in 35 States. We are a Fortune 500 publicly owned corporation with anticipated sales in 1984 in excess of $800 million.

The goal of benefits programs for the Sun Chemical Corp. is the protection and financial security of our 5,500 employees, and their dependents. We do our planning within the parameters of need and satisfaction and the funds available to satisfy these needs and satisfactions.

Consistency and stability are elements basic to providing continuity to a welfare benefits program. In order to achieve this consistency and stability, it's necessary to be able to depend upon the same qualities in the underlying governmental rules and regulations. Otherwise, the result of fragmentation would concern only for short-term results and loss of long-term continuity.

Unfortunately, in recent years governmental rules and regulations have been in such a state of flux that they have severely diluted efforts on behalf of the welfare of our employees. This unstable environment which is a result of Congress' constant rules changing is both costly and counter productive.

It sounds as if I am being very, very picky and very, very pointed toward my complaints about Congress. It might appear as if I haven't looked into the problems that we have faced, that we haven't done ourselves toward making things better. That's not entirely so. If I were talking to a bunch of manufacturers, I would probably be saying many of the same things to them that I am saying to you this morning.

Continuous refinement of legislative rules is understandable, but in order to preserve the strengths of our currently valuable welfare and benefits structure, Congress must be cognizant of the long-range nature of these programs and resist the all too frequent temptation of over regulation.

With passage of the Revenue Act of 1921, tax effectiveness became an important element of a well designed benefit program. So long as an enlightened Congress provides such incentives, tax effectiveness will continue to have a major effect on benefits planning.

The private sector, left to its own devices, with only tax incentives, has in the past achieved major accomplishments in providing welfare benefits to American workers and their dependents. We have not found it necessary to resort to socialized medicine as have other countries, with the consequential, crippling costs and what appears to be a diminuition of essential health services.

These tax incentives encouraged employee benefits to protect the economic security of our employees at Sun Chemical at all salary and age levels. Approximately 70 percent of our employees, 35 percent of which are women, earn less than $25,000 annually.

Sun Chemical's benefit programs are reflective of the private sectors in general and complement Social Security, medicare, and other social welfare programs. The perception of health care and other living standards in the United States is very high and it's based upon its correlation between Government and industry.

I would like to say in conclusion that my company and I both believe that the present system is probably the most effective one that could come about. We have had a modicum of success based upon 26 years of efforts, and any efforts to change it to prevent us from providing the benefits that are so vital to the economic stability of our lower and middle income families would be contrary to the public interest.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Reach follows:]

Statement

on

FRINGE BENEFITS

Presented By

Ernest J. Reach, Manager of Employee Benefits
Sun Chemical Corporation

Before the

Senate Committee on Finance
Subcommittee on Taxation and Debt Management

July 30, 1984

I am Ernest J. Reach, Manager of Employee Benefits of Sun Chemical Corporation, Fort Lee, N.J. I have been actively involved in the development and administration of employee benefit programs for more than 28 years.

Sun Chemical Corporation is a diversified manufacturer of chemicals and equipment, principally for the graphic arts industries, but also in support of the defense establishment. We have close to 5,500 employees domestically, at approximately 50 locations in about 30 states. We are a Fortune 500 publicly-owned corporation with anticipated sales in 1984 in excess of $800 million dollars.

The goal of benefits programs for the 5,500 Sun Chemical Corporation employees is to provide protection and financial security to them and their dependents. Consistency and stability are two of the base elements necessary to the continuity of a pension or welfare benefits program. In order to achieve this consistency and stability, it is necessary to be able to depend upon the same qualities in underlying governmental rules and regulations.

In recent years these rules and regulations have been in such a state of flux that they have severely diluted efforts on behalf of the welfare of our employees. This unstable environment which is caused by Congress' constant rules changing is both costly and counter productive.

Continuous refinement of legislative rules is understandable but in order to preserve the strengths of our currently valuable welfare and pension benefits structure, Congress must be cognizant of the long-range nature of these programs and resist the all too frequent temptation of over regulation.

With passage of the Revenue Act of 1921, tax effectiveness became an important element of a well designed benefit program. So long as an enlightened Congress provides such incentives, tax effectiveness will continue to have a major effect on benefits planning.

The private sector, left to its own devices, with only tax incentives, has achieved major accomplishments in providing pension and welfare benefits to American workers and their dependents. We have not found it necessary to resort to socialized medicine as have other countries, with the consequential, crippling costs and what appears to be a diminuition of essential health services.

These tax incentive encouraged employee benefits protect the economic security of our employees at all levels. Approximately 70% of them earn less than $25,000 annually. There are still gaps that need filling in our plans, but we've come a long, long way.

Sun Chemical's benefit programs are reflective of the private sector's in general, and complement Social Security, Medicare and other social welfare programs. The perception of health care and other living standards in the United States is very high because of the inter-facing of public and private sector funding, which is encouraged by our Federal tax incentive policy. All of this is demonstrative of the best traditions of a free economy.

My company and I believe that the present system of providing health care and retirement income funding through the combined public and private sectors, as developed over a period of 64 years, has had a modicum of success in spite of all the impediments it has encountered and continues to encounter. In my view any change in tax incentives that would serve to reduce or impair Sun Chemical's ability to continue to provide worthwhile programs that are so vital to the economic security of Sun Chemical's low and middle income workers is not in the public interest.

STATEMENT OF WARREN L. MOSER, DIVISION STAFF MANAGER, BENEFIT PLANS, SOUTHWESTERN BELL TELEPHONE, ST. LOUIS, MO

Senator PACKWOOD. Mr. Moser.

Mr. MOSER. Mr. Chairman, members of the subcommittee, I'm Warren Moser, division staff manager for employee benefits plans for the Southwestern Bell Telephone Co., headquartered in St. Louis, MO. We currently operate in the States of Arkansas, Kansas, Missouri, Oklahoma, and Texas, with over 70,000 employees and some 25,000 retirees on our rolls.

My intent this morning is to provide some insight into the importance Southwestern Bell's benefit programs have on the lives and economic security of our employees and retirees. I would like to emphasize that the primary impact of these programs is on the lower and middle level income groups. Last year in 1983 we had 99.4 percent of the benefit dollars expended on behalf of those income groups, while only six-tenths of 1 percent were expended on behalf of senior managers.

I would like to review two major concepts this morning First, that pensions and benefits appropriately receive and should continue to receive a tax favored status under the Tax Code. To understand why, I think we need only look at the administrative costs of providing these benefits Currently, some 227 employees of Southwestern Bell, with an expenditure of some $15 million, are spent internally on the administration and delivery of these programs. In addition, some $20 million are spent externally for third party payers, insurance companies, trustees, and banks for the further delivery of those programs.

My message is both simple and direct. If benefits are taxed on the same basis as wages, why would any company continue to spend such exorbitant sums for the delivery of those programs? I think the answer is that they would not. And I don't think we would.

Inevitably, a result of that would be a diminishment or a discontinuance of those programs with increased pressure on the public sector.

A quick examination of recent government policies, both in the tax area and in the ERISA area, indicates certain questions to the informed person regarding the effect of those policies. For example, plan terminations on pensions in 1983 were at a rate of 13½ percent, compared to some 12.3 percent in both 1982 and 1981, while new plans were being formed at an increased rate of only 6 percent compared to 10.1 percent and 10.9 percent the previous 2 years. There appears to be a real paradox here, it seems to me, in that ERISA was passed originally to protect employees against the loss or alienation of their benefits and now it appears that ill-advised tax policy may leave those same workers with less certainty than they ever had before.

Quickly, then, the second concept I would like to review is that both individual and business plans for benefits are necessarily long term. They are not readily adaptable to change, and both individuals and businesses have relied on and have a right to rely on consistency in Government policy. Rightly or wrongly, Government policy has been perceived by businesses and individuals as well as by unions as being that of providing base programs only. Supplements, if you will, to the programs provided by the private sector. A change in tax rules relative to the benefits could lead to a reversal of the roll, with a significant negative social impact.

In conclusion, I would say I don't envy you your task. I would only plead for consideration of the effects a change in taxatioh would have on the vast majority of our workers. Consider, if you will, the economic impact on the 25,000-plus pensioners that I mentioned earlier. I assure you of our corporate concern regarding your deliberation. I would offer you any assistance both now and in the future that we might be able to furnish.

And I thank you for this opportunity for us to share our concerns.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Moser follows:]

SUMMARY OF STATEMENT OF W.L. MOSER, ON BEHALF OF SOUTHWESTERN BELL TELEPHONE CO.

Favorable tax treatment of pensions and benefits provided by Southwestern Bell Telephone Company has a major impact on lower- and middle-level employees and retirees, that large majority of our work force for whom 99.4% of company benefit and pension expenses were incurred and paid in 1983. There are two primary concepts to consider in support of the importance of benefit programs on the lives and economic security of our employees and retirees.

(1) First, that pensions and benefits provided through the private sector appropriately receive, and should continue to receive, a favored status under the tax code. The absence of such tax incentives will lead to reductions in such programs in the private sector and, inevitably, to demands for extension and expansion of such programs from the public sector.

(2) Second, that current programs offered by Southwestern Bell Telephone and other major employers are the result of businesses' perception of long-standing government policies, and that significant alterations of such policies bring about substantial negative economic consequences to business and employees. Employees plan for their retirements over extended periods of time. In doing so, they have relied on, and have a right to rely on, consistency in government policy relative to those aspects of their retirement security most affected by government—principally Social Security and Medicare but also governmental involvement with their pensions through ERISA, TEFRA and DEFRA.

Any contemplated changes in tax treatment of benefits should take into account long-term consequences. It is critical to recognize that lower- and middle-level employees are those most affected by government policy changes.

STATEMENT OF GEORGE E. PERRIN, MANAGER, BENEFITS PLANNING AND DEVELOPMENT, EASTMAN KODAK CO., ROCHESTER, NY

Senator PACKWOOD. Mr. Perrin.

Mr. PERRIN. Mr. Chairman, and members of the subcommittee, I am George Perrin, manager of benefits planning, and development for Eastman Kodak Co. This will hardly be new, but we would like to add our voice to those who have commended you for taking the initiative in holding these hearings. And, further, we want to thank you for the opportunity to appear and comment on tax policy issues as they affect employee benefits.

We are here because we believe firmly that the system of private pension and welfare benefits, as it exists today, is a valuable and necessary socioeconomic institution, helping to meet the security needs of millions of Americans. As only one example of that system, Kodak has a pension and benefits program for all of its 84,000 U.S. employees. In addition, another 29,000 individuals are currently receiving retirement, disability, or survivor benefits.

A program such as Kodak's does not spring into being overnight. Rather it matures and evolves over many, many years. In 1929, when our retirement plan was introduced, there were less than a dozen retirees in that first year. Forty-five years later, in 1974, the number had grown to 12,000. In 1984, we are currently paying benefits to 22,000 retired people, a ratio, by the way, which is one retired individual for every four active employees.

In order to meet commitments to employees that emerge over long periods of time, employers must prefund benefits throughout the course of the employee's working career. I think a previous witness indicated that it really isn't as of much significance to the employer to get that deduction for a contribution to a tax qualified plan as it is important to the employee's ultimate security that that benefit be there when he is ready to retire.

A favorable tax and legislative climate in the past has been a very significant factor for Kodak and for other employers to fund this system to meet these commitments. I would like to suggest that a stable and predictable legislative regulatory environment is absolutely essential to the continued health and welfare of the private system. And to encourage the introduction of new programs.

Frankly, personally, I would find it very difficult to initiate a program of the magnitude and scope that we sponsor today in the current climate. That's my feeling; not my employer's.

When tax incentives to encourage private plans are provided by Congress, then Congress is rightly concerned that they not be discriminatory. We strongly support this proposition. However, we would like to point out that coverage under major large benefit programs is already very broad based and nondiscriminatory.

Again, if I may, using my own company as an example, all employees, hourly and salaried, from the CEO to the mail clerk, are in one comprehensive program. Participation in our defined benefit pension plan is immediate upon employment and the majority of participants can be characterized as being in the lower paid or middle income brackets.

Mr. Chairman, we believe that it's inappropriate to have tax policy be the primary or sole force impacting pensions and welfare benefits. For this reason, we would like to see an effort made toward establishing a broad based national policy for pensions and benefits. And we would be very supportive of that.

Thank you.

Senator PACKWOOD. Thank you, Mr. Perrin.

[The prepared written statement of Mr. Perrin follows:]

STATEMENT

OF THE

EASTMAN KODAK COMPANY

BEFORE THE

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARINGS ON THE SUBJECT OF FRINGE BENEFITS

July 26, 1984

Mr. Chairman and Members of the Committee, my name is George E. Perrin, Manager, Benefits Planning and Development for Eastman Kodak Company (Kodak). Kodak is a 104-year-old domestic corporation with world headquarters in Rochester, New York, manufacturing units in nine states, and marketing, distribution, and processing services situated throughout the country. Kodak provides benefits and pension programs for all of its approximately 84,000 domestic employees, and another 29,000 individuals receive retirement, disability or survivor benefits.

We appreciate this opportunity to appear before the subcommittee to comment on tax policy issues surrounding employee benefits. We are here specifically to discuss the need for long-term stability of pension and benefits program so that our employees can plan their individual decisions over a lifetime.

The private system of pensions and welfare benefits sponsored by American employers is a necessary socio-economic institution, and in order to grow in a healthy manner, or even to survive, the private pension and benefit system is dependent upon reasonable tax incentives and -- very importantly -- a stable legislative and regulatory environment.

Concern in the Congress for the size of the deficit and the erosion of the tax base is understandable. Most Americans share that concern. However, we believe it is critical not to let that concern overwhelm and further erode or take away altogether the security and protection afforded American workers by the private pension and benefits system. Workers will continue to feel a need to protect their families from the unexpected death of a breadwinner or the high cost of health care and want reasonable security in retirement. We know that you too have the same concerns about the security of workers and their families.

We've all heard stories about "fat cats" in connection with employee benefits. But how much do we ever hear about the "little guy" and his security needs? Ordinary lower and middle income employees constitute the vast majority of participants in Kodak's benefits program as they do in programs of all major employers. I'd like to share the stories of two such real people with you:

John is an employee -- 51 years old -- whose oldest son had a tragic accident two or three years ago. At the time, the boy, age 21, was a first-year medical student. He experienced a traumatic head injury and will never be able to care for himself, although he can expect to live a long life.

John has already suffered a heart attack, a matter of some concern to him in the light of his son's condition. Under Kodak's Family Protection Program, John's wife (or his son) is eligible for life insurance protection of up to six times his salary.

When John is retirement eligible in a few years, his wife can be covered by a survivor income benefit equal to 50 percent of John's pension. In the event that both parents predecease the disabled son, the son would then become the lifetime beneficiary of this survivor income benefit.

In addition to the life insurance and survivor income protection, John's wife and/or disabled son are eligible for lifetime coverage under our Survivor Health Care Program. The real value of all of this to John is the knowledge that his disabled son has a source of income for the rest of his life if something happens to John. Benefits provided John's son under this private program can also serve to reduce the likelihood of the son becoming a public charge.

Or take the case of three-year-old Jesse, who has suffered from a rare disease that prevents his body from producing immunities to illness. For this reason Jesse has had to spend much of his life in a germ-free hospital room. To date, the Kodak health care plans have paid over $500,000 for expenses incurred by Jesse for hospital confinement, bone marrow transplants, etc. Very few of us would be able to cover even a portion of such a medical bill if we had to do so from our personal resources.

The question isn't that human needs for protection and security don't exist -- the Johns and Jesses of this country will always be there. The question really is, "who will meet these human needs, the private or public sectors?" We firmly believe that both share a responsibility -- neither one can do it alone. Where one or the other system is curtailed, there is a corresponding burden on the other. And the public system is already in trouble, as evidenced by the concerns for Social Security and the shifting of an increasing part of costs previously borne by Medicaid to the private sector. At the same time, a proliferation of legislation and regulation is threatening to cripple the private system and weaken its ability to make up for the shift in benefits from the public sector. Especially vulnerable, it seems to us, is the defined benefit pension plan.

Under a defined benefit plan an employer promises a "career" employee (variously defined as one who works for an employer 25, 30 or 35 years) a determinable benefit which will replace a certain percentage of his or her salary. The benefit is usually paid in the form of an annuity with monthly payments. Commonly, the benefit is based on the average of an employee's pay in the final three to five years immediately before retirement. That benefit is integrated with Social Security to provide, for example, a combined benefit of 75 percent-85 percent of final pay for a lower paid employee.

For example, a "career" employee whose final pay is $20,000 might receive combined retirement income from his or her employer's plan and Social Security of 83 percent of final pay.
There are at least four reasons why defined benefit plans are of greater importance to American workers than defined contribution plans:

First, the employer commits to and assumes the obligation for providing a specific benefit at retirement. The employer is required to make necessary contributions (relatively few major defined benefit plans require employee contributions) in order to fund the benefit, and bears the risk of investment performance. In the event that investment return is not favorable, the employer is responsible for making up any shortfall. Under a defined contribution plan, if investments go sour, it is the employee who assumes the risk.

Second, a retirement benefit under a defined benefit plan, since it is established by formula, is predictable. Employees can have a good idea of what to plan on many years in advance.

Third, unlike savings and other defined contribution plans, the majority of defined benefit plans do not permit lump-sum distributions. Therefore, early dissipation of assets is impossible, and there is a much greater assurance of a continuing stream of income payments for life.

Fourth, employers sponsoring defined benefit plans have been sensitive to the erosion of purchasing power that occurs during periods of high inflation. As a consequence, many employers adopted an informal practice of granting benefit increases from time to time (Kodak is one such company). In cases where a defined contribution plan is the only retirement vehicle, it is completely up to the employee to protect his or her retirement benefits from inflation.

A story from the early history of our company illustrates why we feel the way we do about defined benefit plans:

In 1912, George Eastman, Kodak's founder, established a profit sharing program which he called a wage dividend. The idea was that just as stockholders receive dividends, employees should receive a dividend based on the fruits of their labor. In addition, Mr. Eastman felt that his wage dividend would provide his employees with a means of saving for their retirements. However, there was only one problem: human nature being what it is -- and I personally don't think it has changed very much in the intervening years -- Eastman observed that the annual dividends being paid by the company were going for more immediate things like automobiles and that at retirement employees did not have the expected savings.

Accordingly, Mr. Eastman introduced a defined benefit retirement plan in 1929 at the same time that he inaugurated a group life insurance plan and a total and permanent disability benefit plan. That defined benefit pension plan has been in continuous existence for the 55 years since 1929.

As a mature plan, Kodak's defined benefit plan is currently paying benefits to more than 22,000 retirees, a ratio of better than one retired person for four currently active employees. Just 10 years ago there were only 12,000 Kodak retirees. As a matter of trivia, our oldest retiree will be 98 this year. He has been retired for 38 years; ten years longer than his Kodak working career of 28 years.

Participation in the Kodak retirement income plan is immediate upon employment, and there is no distinction made between hourly and salaried employees -- all, from the CEO to the newly hired mail clerk are in the one plan. Currently, the Kodak retirement income plan covers 84,000 active employees.

The career employee who is at the lower end of the wage/salary structure and who retires in 1984 will receive 80 percent of his or her final salary from a combination of plan benefits and

Social Security. The individual at the higher end of the salary structure will receive a replacement of approximately 55 percent of salary.

In addition to pension income and substantial death benefit protection, retirees are covered under a comprehensive health care and dental program which costs Kodak approximately $1,300 per year for a retired person and his or her spouse.

Favorable tax law through the years has been a significant factor in Kodak's ability to provide a substantial level of security for retired and active employees. A mature pension and benefits program like Kodak's just doesn't develop overnight. A population of retirees emerges gradually over a long period of years, and it is necessary to provide for this throughout an employee's entire working career.

Tax incentives have encouraged employers to pre-fund for benefits that are not due and payable for many years down the road. The sheltering of income produced by pension trusts has further increased the ability to meet plan commitments. As a result, money is there to secure a promise when people retire. This fact was recognized by Congress when it passed ERISA. On the other hand, a deduction on a pay-as-you-go basis is a very unsatisfactory way of assuring a retirement benefit, or for that matter post-retirement life and health benefits.

We believe it would be entirely inappropriate for the nation to get into a situation where, due to lack of proper incentives, the burden for employees' health care, life and disability protection and retirement security now being borne by the private sector would shift to the government. The government already has its own problems financing existing promises.

There is another reason why we believe it is important to encourage employers to sponsor pension and benefit plans. Benefits are needed to attract and retain people and are an important element of compensation. However, in order to stay competitive, employers must run plans on a cost effective basis. Private employers have a built-in incentive to keep plan costs down since we pay the cost of benefits. That is especially important for U.S. companies, like Kodak, who are competing in world markets.

Pension and welfare benefit plans are adopted for the long term and cannot function properly in a constantly shifting (chaotic) environment. The legislative and regulatory process in recent years is a disincentive to the establishment of new plans, especially a defined benefit plan, which may already be on the endangered species list.

A stable and reliable environment is important for the following reasons:

First, it encourages employers to establish programs, with long-term commitments to employees' welfare and security.

Second, employees need to be confident that they can rely on their employers' programs over many years -- an entire working career and beyond -- in order to assure adequate planning for their families' security.

Third, complying with frequent and erratic changes in law and regulations is very time-consuming and costly -- wasteful, in many cases. These costs are reflected in the costs of doing business, and again are reflected in U.S. industry's ability to compete with foreign manufacturers. As result of this process, everyone loses: employers and government lose revenue and employees get no improvement in benefits.

Let me cite a small but important example of how the current process impacted our ability to fulfill a long-term commitment to employees made under our pension plan.

For years Kodak had provisions in its defined benefit pension plan which permitted all participants to provide any survivor, not just a spouse, with an assurance of lifetime income by electing a joint and survivor annuity. Employees who had no spouse upon retirement could elect to have a brother, sister, disabled child, or any other person whom the employee supported as a contingent beneficiary of his or her pension benefit. Through this election, the employee could assure a continuing stream of lifetime payments to the dependent.

Then, TEFRA amended the Internal Revenue Code to restrict survivor annuities for non-spouse beneficiaries to no more than five years -- in effect making a lifetime payment impossible. Remember John and his disabled son in my previous anecdote? TEFRA prohibited us from paying the 50 percent survivor benefit out of our pension plan.

Further, employees who were contemplating distribution in the form of installments from our savings plan were impacted. They now had to contemplate a 100 percent distribution over their lifetimes instead of 50 percent, thus eliminating any residual amount for survivors. This change forced Kodak and its people to find alternative means of providing for survivors.

The law provided a transition rule which grandfathered previous elections of all plan participants as of December 31, 1983. A major effort was mounted to amend the benefit plans by January 1, 1984, in order to retain qualification status.

Then, in mid-November, 1983, the IRS published a notice which for all practical purposes nullified the grandfather provisions. It would have required educating and receiving informed elections from 84,000 employees located across the United States in just one month. Furthermore, it would have required very young employees to make a current election with respect to form and timing of a benefit distribution which would not be made for many years.

So, at the 11th hour we had to restructure plan provisions.

Since the first of 1984 we have revised and published several employee publications to explain the new TEFRA rules, oriented more than 100 specialists who administer the plans and counsel employees, and modified several computer systems.

Now, just seven months later due to the repeal this month in the current tax bill of TEFRA's special distribution rules, we must repeat the process. While we are pleased with the ultimate action Congress took on this subject, the unsettling aspect of this scenario is the rapidity and frequency with which changes in the law occur. These changes disrupt the rational flow of long-term plans and commitments to employees, and create costs which impact the price of goods and services. This situation is not unique to Kodak, but experienced by any company providing progressive employee benefits.

Mr. Chairman, it does not seem to be appropriate to have tax policy be the sole engine driving legislation and regulation impacting employee pensions and benefits. Long-term concern for employees and their survivors should be carefully considered when making short-term decisions regarding immediate revenue needs. Accordingly, we would strongly support an effort that would lead to a broad non-discriminatory national policy on pension and benefits. Further, we believe it is essential to have representatives of the private benefits community participate in that effort.

Finally, we would welcome the opportunity to share our experiences in developing and administering a major benefits program and would like to invite members of the committee staff to dialogue informally with our staff people who are involved in the day-to-day operation of our program. Thank you.

Senator PACKWOOD. Let me ask each of you just one question. It is a political question, a lobbying question. It probably doesn't apply to you, Mr. Sharpe, because you are the CEO of the corporation.

We have had very little contact from the principals, the presidents, and CEO's of corporations on this subject. When we were debating this subject in the tax conference, Pepsico gave us some very good information on it. They shifted their health plan from a defined benefit plan to a cafeteria plan. Indeed, the employees opted for some lower benefits plans. They took money instead. The Treasury actually gained money on the shift. They were using it as an example of how they were paring health costs and giving employees more variety.

I asked the lobbyists if Mr. Kendall had ever called Secretary Regan or President Reagan, as the case may be on this, and I think, Mr. Badgett, your ultimate boss probably would have the contacts to do that if he chose to do that. What I sense when I go home or any place else is that principal officers of the corporation do not bring this subject up. They will remember 1981 when we had the tax plan. One of the big issues was 10-5-3 on depreciation, 10 years for real estate, 5 years for personal property, 3 years for cars and light trucks. There must have been dozens of CEO's who contacted me on that. But not on this.

Does it really reach a sufficient level of importance to the presidents or CEO's of your corporations that they are willing to lobby this hard or is this really of more interest to all of you, save Mr. Sharpe, who are involved directly in the management of these plans and to whom it is an obvious concern?

Mr. Reach.

Mr. REACH. My perception is that the president and chief operating officer of our corporation is very interested in this point, and would give a lot of support for it.

Senator PACKWOOD. Would, but haven't though.

Mr. REACH. They have in the past, yes.

Senator PACKWOOD. Have they?

Mr. REACH. Yes.

Senator PACKWOOD. Mr. Moser?

Mr. MOSER. I would answer it in two ways. One, I think the field of benefits is a highly technical one that most CEO's would feel somewhat uncomfortable with. If it's something involving the operations, most of them have risen in the ranks of the company through the operation of departments and feel more comfortable to address issues like that.

Senator PACKWOOD. Let me interrupt you for just a moment. Ten, five, three, with all of its variations on depreciation is as equally complex as this.

Mr. MOSER. But, again, Senator, I think that maybe they have more involvement in that in the day-to-day operations of the business whereas the benefits field tends to remain remote. I don't like that. I'm just saying it's a reality.

The other part, I would say, in our company—my CEO knows what I am saying here. He has reviewed my testimony. I have reviewed it personally with the vice president of personnel before arriving in Washington. I believe that if there was some doubt as to what I was saying, there would have been evidence of that before I left.

Senator PACKWOOD. It isn't doubt. It's really use up a chit to lobby for this.

Mr. MOSER. I'm not certain. I don't know. Again, I think in the lobbying arena, the CEO's are weighing what they are asking for on one hand versus what they are asking for on the other hand. And in our particular industry, as you probably know, we are getting a lot of guidance and direction from the Government.

Senator PACKWOOD. Mr. Ragland.

Mr. RAGLAND. Senator, my sense is that the question you are asking is how does it rate in our hierarchy of CEO needs, wants, and desires. And my sense is that a lot of the CEO's in this country have got a hierarchy that essentially falls this way. No. 1, Federal deficits. I think that is what has got them scared. And then you go down the list where you have got the tax department coming in and saying we have got a problem with Congress considering, say, a tax on corporate economic income. We have got a situation of creeping repeal of the ACRS system. And these things are bottom line, profit and lots oriented issues that hit right now, third quarter, fourth quarter, first quarter, second quarter. They involve what the CEO is able to do on Wall Street, with the financial community. They involve the sale of stock and so forth and so on.

Employee benefits, on the other hand, is a situation where it's working. And that's the point that I tried to make. It's working. Leave it alone. It doesn't need to be fixed. We have right now a qualified work force, perhaps one of the best educated work forces in the world, if not the best educated work force in the world.

And what we are saying is that this situation developed through a reasonably well worked out series of incentives and programs in the employee benefit area. And that what we need to do is maintain that commitment to make sure that we go into the 1990's and the year 2000 with a work force that continues to be qualified; particularly, as we go into more and more mechanized production procedures and things along this line.

So would the CEO use up a chip on this? I doubt it. I doubt you will see one walking through the door with a baseball bat in his arm; making other decisions based on this. But they are aware of the competence of the work force They are acutely aware of the health and the happiness of their employees. But right now I think that they are more concerned with assuring that there is a job there for that man to fill or that woman to fill and that they are satisfied with that level of employment. That would be my answer to your question.

Senator PACKWOOD. Mr. Sharpe.

Mr. SHARPE. I don't think I have much to add to what has just been said. As I pointed out in my original remarks, our company, like other. machine tool companies in this country have been struggling mightily against Japanese and foreign competition. With the tremendous change of circumstances, the attention of CEO's in our industry is focused on operational matters, and we have not had a lot of extra time or resources to try innovating in the world of fringe benefits. That doesn't mean we are opposed to the idea. In fact, I am personally attracted to moving in many phases of management and the work environment, toward increased individual choicemaking and participation. That seems to me to be the way of the future. I have no resistance to the idea.

Senator PACKWOOD. Mr. Badgett.

Mr. BADGETT. I would say that Motorola is truly a people oriented company, including our chairman of the board, Bob Galvin. And employee benefits are one of his major areas of concern. He takes a great deal of participation in all decisions affecting benefits, and it's a big concern to him. And, in fact, he did send a telegram to all the members of the Senate Finance Committee when the tax bill was being considered. So I would say yes, he's extremely interested.

Senator PACKWOOD. Mr. Perrin.

Mr. PERRIN. My immediate response to that, Mr. Chairman, is that I wouldn't be here today if I didn't have the support of our president and CEO. Now as far as his personal involvement, I can't answer for that other than that employee benefits and pensions have been a very serious matter for Kodak for 55 years. I suspect that with respect to many people in business in the high echelons perhaps the problems that we are perceiving down here more at the working level, that the awareness of that probably is not as great.

Senator PACKWOOD. I will make you a bet. I think Mr. Ragland is probably right. If by chance, Vice President Mondale were elected, and one of his tax plans was a 5-percent increase in the corporate profits tax, we would have the CEO's of all your companies here personally testifying in opposition to that particular tax effort. They would regard that, as Mr. Ragland has said, as affecting this quarter, next quarter, stock profits. That would be a high priority.

All I can say to all of you is the philosophy has changed—not with me. But 5, 6, 7 years ago everyone thought that employer provided benefits were good and should be encouraged. In a space of 3 or 4 years we adopted van pooling and prepaid legal and educational assistance and everyone said fine. That philosophy has changed and the tide is now running against us rather than with us. It will continue to do so unless one or two things happens.

If enough CEO's of major corporations get to the President and say, Mr. President, look what you are doing; look what is going to happen, and the President said no, we are not going to have that, that would be the end of it for the duration of his administration. Short of that, it is going to be a long, uphill battle with the administration and the Treasury and a fair portion of this committee and over half of the Ways and Means Committee against not only further extension of employee benefits but probably taxing them or cutting them back.

Jack?

Senator DANFORTH. I'm tempted to ask whether the CEO's of your various companies are interested in the size of the deficit, but I won't.

The Joint Committee on Taxation staff has provided us with a booklet and it has some tables in the booklet. And the tables indicate that between 1950 and 1981 employer contributions to group health and life insurance as a percentage of wage and salaries has increased.

Can you tell me in the past, say, quarter of the century has the cost of fringe benefits as a percentage of wages and salaries been going up or has it been going down or has it been staying about the same as far as your businesses are concerned?

Mr. REACH. Senator, if you will let me address that. It has been going up in our business. And 2 years ago, for the first time, we required employee contributions for our health insurance program. The health insurance program, the traditional type, the Blue Cross and Blue Shield type, is what—we have two plans. One is a comprehensive health insurance plan that does not require employee contributions.

Senator DANFORTH. But just in the aggregate as far as the employer cost is concerned.

Mr. REACH. Yes.

Senator DANFORTH. For all the fringe benefits, has it been in the last quarter of the century been going up? And has it been going up, would you say, significantly?

Mr. MOSER. Senator, if I might. I think a close analysis in our company would reveal that the greatest increase has been in the medical area. The other benefits have remained relatively constant. Now I think that there is a reason for this and I kind of wish Senator Durenberger was here because he addressed this point earlier.

I think that there is a reason for why the medical costs have risen so dramatically. One is that when the plans were originally bargained with the unions—and ours was—the bargaining was not over what the content of the plan was. It was over how it would be paid. The plan itself was a high first dollar coverage and it was on a schedule. The combination of employee payment and the schedule tended to control the radical increase in costs. In 1971 when we changed to a reasonable and customary level rather than on a schedule and also went to 100 percent employer-paid premiums on the plan, that's when the dramatic increase in costs came. In retrospect, I wish we had not done that. But at the time reasonable and customary seemed like a reasonable solution for the pressures that were being applied to us in the bargaining process for raising the schedules.

Senator DANFORTH. Instead of the general, I mean have fringe benefit costs been going up or have they been the same or have they been going down? And then would you expect—another table in this book indicates that between 1984 and 1989 there will be a significant increase in the cost to the Treasury in lost revenue as a result of fringe benefits. For example, between 1984 and 1989, the loss of income taxes from employer contributions for health insurance was expected to go from $17.6 billion to $34.1 billion in just income taxes alone, not mentioning Social Security.

And I was wondering if that history of increase as a percentage of wage and salaries has been the case in your company. And, further, if you would anticipate that the cost of fringe benefits is going to continue to go up, and if so, whether it will go up faster or the same as or slower than the cost of wages and salaries.

Mr. MOSER. What I am saying to you is that relative to medical care, the costs have gone up. I think the trend is clearly in the area of introducing more cost sharing and more deductible plans, and I think you will see this, and I think that the tendency will be to curb it because businesses can't afford it. But if you look at the other major contributors to benefits costs—and I'm talking primarily pensions—those have not gone up significantly. Life insurance has not gone up significantly. The area where we have not exercised control, and I have explained why, has been in the medical area. And I think if we put that one under control, we can do the job in the private sector.

Senator DANFORTH. Anyone else care to address the question?

Mr. BADGETT. Well, I was just going to say that within Motorola—and, in fact, we may be typical. If you go back the 25-year period, there were a lot of benefit improvements in, say, the last 25 years; primarily, in the area of medical plans, adding new dental plans, increased vacations. In the last 3 to 4 years, though, I think there has been a marked change in most companies, including us. Our costs have gone up only because of the medical expenses. And we have taken steps to stop that. If we are successful in the area of containing the health care costs, we don't anticipate in that time period you described any change in our benefits costs as a percentage of pay.

Mr. PERRIN. I would say at Kodak that costs—in terms of dollars expended—have increased. But as a percentage of pay, they have remained relatively stable. And I think in a sense this reflects, as I was trying to say before, the experience of a mature program. We have shared the cost of health care premiums with employees since the 1970's so there was some dampening on the employer's expenditures resulting from the increase in health care costs.

We have a final pay pension plan, pension plans do tend to increase with salaries. But, again, as a percent of pay they have remained relatively stable.

Senator DANFORTH. Mr. Sharpe.

Mr. SHARPE. And Rochester, if I recall, is your headquarters town. It has got the best health care containment program of any city in the United States.

Mr. PERRIN. I'm sorry Senator Durenberger left.

Mr. SHARPE. And that's partly a Kodak happening.

Senator DANFORTH. What is your experience, Mr. Sharpe?

Mr. SHARPE. The reason I'm here today is because we got ourselves a Blue Cross increase unilaterally of over 30 percent a year or so ago, and nobody asked us whether that was all right or not. So after the fact, we decided it wasn't all right. And we formed this organization to start buzzing around the hives and getting something done, and here I am. [Laughter.]

Senator DANFORTH. Mr. Ragland, some witnesses have said that these fringe benefits are really a saving to the Government because the Government—if benefits weren't paid as fringe benefits, the Government would be doing it. Has our Federal budget been better off as a result of the fringe benefits, or have they been in addition to Government programs, in your opinion?

Mr. RAGLAND. My sense is that we are probably better off with the current system than if we started to move a lot of the programs into the Federal sector.

Senator DANFORTH. I mean have we in the history of fringe benefits, has the budget decreased? I don't think so.

Mr. RAGLAND. The Federal budget for this kind of stuff? No, I don't think that's——

Senator DANFORTH. I think the Federal budgets for these things has been going up and the revenue lost because of the tax-free nature of fringe benefits has also been going up at the same time so we have been given a double whammy.

Mr. RAGLAND. Well, let's follow the thought out a little bit, if we could, Senator. I think where we go—if we move, let's say, to a less involved corporate community in the provision of, say, health costs, I don't think that the expectation of quality health care would go down in this country. People would still demand it whether they are in a clerical position or a senior management position. People are going to demand high quality health care.

Senator DANFORTH. I would say that it's debatable that the quality of health care is necessarily equated 1 to 1 with the amount of money you spend on that health care. It just seems to me that we have a problem. And it's a $200 billion deficit. Most business people I know understand that. They think it is terrible to have a $200 billion deficit. They think that we are really hurting the country, short term and long term. We are really hurting the country with deficits this size. And then we look at what we are spending for the same kind of programs, direct spending for the same kind of programs, that are provided for by the fringe benefits. And then we look further at the increased cost of fringe benefits and the increase in fringe benefits is a percentage of wages and salaries over the last 30 years or so and then we look at the projections of the increased revenue costs to fringe benefits to the Treasury over the next 5 years, and the business community comes in and says, oh, it's too unsettling to us for you to consider changing this.

Maybe this is the same as everybody else who comes in. Let somebody else solve the deficit. Maybe we can put in place the Grace Commission or something and that will take care of our problem for us.

But it just seems to me that when we have a major deficit problem, and when we have not a reduction of direct Federal outlays for these programs during this period of time, but an increase, fringe benefits have not offset Government spending. Government spending has gone up with or without fringe benefits. Then to say, well, status quo, status quo. I mean if you were in our shoes—and maybe it's political poison. I am sure it is to suggest any changes—but these fringe benefits are entitlement programs. Let's face it. These are entitlement programs just like any other entitlement programs. In your opinion, should we do anything about entitlement programs or just forget them?

Mr. PERRIN. May I comment?

Senator DANFORTH. Sure.

Mr. PERRIN. First, I have difficulty lumping everything under the broad title of fringe benefits. I tend in my own thinking to establish a hierarchy, and the keystone in that hierarchy is retirement security. And in looking at what we urge which is to determine a national policy toward pensions and benefits, I think you have to get in and analyze what this benefits animal is. The defined benefit pension is most important. And, frankly, my concern is that we not disturb a system which in combination with Social Security is allowing a lot of people to lead good, comfortable retirement lives.

Senator DANFORTH. I don't think anybody is suggesting touching qualified pension plans. I think really the question is there some way that we can get a grip on the whole fringe benefit concept or do we take the position that we in the Congress really prefer fringe benefits over other methods of compensation, and we are going to encourage more and more through cafeteria plans, zebras, and so on and so forth.

Mr. PERRIN. Well, they are down on the benefits scale.

Mr. RAGLAND. May I jump in for just a second, Senator?

Senator DANFORTH. Sure.

Mr. RAGLAND. I'm not entirely convinced that the fact that the amount of money that has been committed to so-called noncash compensation shows that there is a policy in the business community to pay people in other than cash. I'm just not sure that that is there.

But coming back to your point on the deficit situation, you are right. There is a major problem there. And NAM has spoken on that enumerable times. But when you sit down and take a look at special analyses which has, all these programs in it, the so-called "cros-Treasury programs—revenue loss programs—I mean which of those do we start throwing out. Special analysis G is entertaining reading if you sit down some evening and go through that thing. I can't even tell you what some of them are. But what we are doing here is we are moving toward some kind of flat based tax system, and we are saying, well, we have got to take something from fringe benefits, we have got to take something from home mortgage interest, we have got to take something from the old people, the young people, the infirm, the not infirmed, the Catholics, the Methodists. That's not the way we need to raise revenue in this country to the extent that revenue needs to be raised.

The line that we have followed or have been preaching now for a couple of years is that you first cut spending and then you go and raise revenue.

Senator DANFORTH. I agree with that.

Mr. RAGLAND. And that is why we have attached at the back of our comments the proposals that we sent to the Treasury Department for moving toward a value added form of taxation in this country as a supplement to the income taxation. Quit tinkering around with the system that we have got. It's just not that bad. Let's go ahead and put an add on and raise the revenue necessary to balance out this red ink that we are dealing with. And the situation of the national debt, we would deal with with another set of considerations. But right now let's deal with the $170 billion that we are going to have to book this year in addition to the national debt.

Senator DANFORTH. You are not concerned about these projected costs of the doubling of the costs to the Treasury, of the cost of fringe benefits over a 5-year period of time?

Mr. RAGLAND. Senator, numbers amaze me in this city. Everybody has got a number. Treasury has got a number. The GAO has got a number. The White House has a number. We have a number. Everybody has got a number.

And, no, it doesn't concern me because I think we need to have a commitment in this country to a qualified work force, a healthy one, productive one, and not be worrying about whether or not somebody is parking in a paid parking spot. That's just not the direction that I think we need to worry with at this point in time.

Senator DANFORTH. Does anyone else have anything to add to the good of the cause?

Mr. SHARPE. Could I just reiterate another gut feeling? Everybody is in sympathy with getting this deficit in order; my Lord, that certainly is important.

Senator DANFORTH. As long as we don't touch you.

Mr. SHARPE. I suppose that's right. [Laughter.]

But it just seems to me that if you start tinkering with the established framework of employee benefits—especially in the realm of health care—then you are going to pull the whole hay mow down on your head; the American people don't need that.

Senator DANFORTH. Mr. Sharpe, you testified that 23 percent of your payroll—let's see, what do you say? In 1983, we spent a little over $5 million on employee benefits. This represents 23½ percent of wages and salaries.

Mr. SHARPE. Right.

Senator DANFORTH. That's dynamite. Is that going up or down?

Mr. SHARPE. I would think that if we are not successful in getting uncontrolled fringe benefit costs down, we are not working hard enough. In reference to the 23½% you just mentioned, that figure represents both government mandated fringes and voluntary ones. Moreover at the 23½% figure, we are at the lower end of the various RI employers in the group I am representing, the whole group ranges from 22 percent, slightly lower than ours, up to as high as 36 percent. And that's a——

Senator DANFORTH. And, in fact, Uncle Sam is paying for 46 percent of that portion of compensation.

Mr. SHARPE. If the revenue has to be raised—and I certainly don't dispute that—it just seems to me that there are other portions of the equation that ought to be looked-to and asked to ante up. But if you ask the fringe benefit portion of the equation to do so, you will simply cause more discombobulation than is necessary. That's a personal opinion. I'm not an expert in this area. I'm just a guy trying to make a buck.

Mr. MOSER. Senator, if I might add. I think a message that has been communicated here repeatedly this morning is not one of saying don't touch it. I think what we have said is use caution in touching it. Try to establish some long-term policy, something that businesses can adhere to, something that we can plan on with some consistency because it is too disruptive on the lives of our pensioners and our employees. And I think Senator Packwood addressed this point earlier in his earlier comments. And I agree with those.

Senator DANFORTH. Do you think that we can agree that at least we don't want to set in motion something that would balloon fringe benefits? I mean, for example, the zebras.

Mr. MOSER. I think the zebras were clearly a bad proposal. I don't think that major businesses responded to those significantly. I think that there were a few companies that adopted them because they were available. And I think when loopholes like that are discovered, they ought to be closed.

Senator DANFORTH. How about VEBA's? How do you feel about them?

Mr. MOSER. VEBA's, I don't think, are in the same category. I think that VEBA's are a matter of prefunding. I think that they clearly follow some of the fast beef standards that are required for medical costs for retirees. And I think for particular kinds of programs, they ought to be considered.

Senator DANFORTH. All right. Your deduction early.

Mr. MOSER. I don't think it's a matter of that. I think it's a matter of ensuring that the benefit is going to be there when the person who has worked his entire life and is now passing into retirement has a right to expect that that benefit is going to be available.

Senator DANFORTH. I thank you all and I appreciate, Mr. Chairman, the opportunity to have my questions beyond any reasonable amount of time.

Senator PACKWOOD. Let me call you on one factual statement that you made. You said these benefits are growing, both fringe benefits costs and at the same time the Government cost for the same services are growing. I don't think that is true in health coverage. Health coverage grows in two great areas—medicaid and medicare. Those are two areas that employers do not cover, by and large. In the medicaid situation, it is usually for those on welfare or unemployment, medicare is for retired people, and only very recently have any employers to any great degree gone into covering people who are retired.

What it costs in terms of lost income—assuming the Joint Committee's July 24, 1984 estimates are right, is that we will lose $20,200,000,000 in income tax collections because of the tax free status of employee benefits, health benefits. It is my contention that if we didn't have those benefits, you would have the equivalent of medicare or medicaid for all of the population. That would cost us infinitely more in taxes or else the deficit would be infinitely greater to achieve worse coverage and less responsive coverage than we get for the $20,200,000,000 we forego to encourage employers to provide it.

Thank you very much.

Senator PACKWOOD. We will conclude with Timothy Williams, director of human rescurce planning, Owens-Illinois; and Dean Bard, general manager, payroll and employee benefits, MAPCO.

Mr. Williams, go right ahead.

STATEMENT OF TIMOTHY L. WILLIAMS, DIRECTOR OF HUMAN RESOURCE PLANNING, OWENS-ILLINOIS, INC., TOLEDO, OH

Mr. WILLIAMS. Mr. Chairman, and distinguished members of the Subcommittee on Taxation and Debt Management, my name is Tim Williams and I am director of human resource planning for Owens-Illinois, Inc. My company, with headquarters in Toledo, OH, employs in excess of 8,000 salaried and 24,000 hourly workers located in 120 communities throughout the United States, with 1983 consolidated sales of over $3.4 billion.

Owens-Illinois believes the tax law should encourage employers to provide fringe benefits. Those benefits or services currently favored in the Internal Revenue Code should continue as well as the existing type and level of tax incentives, if it remains a national commitment to provide a system of private and public economic security for workers, survivors, retirees and their dependents. Contemplated revisions should be analyzed in light of the social outcome of any restructuring of the Internal Revenue Code. If the objective is purely to reduce tax expenditures without cognizance of the broader societal goals, an incoherent and possibly dangerous situation occurs. The rush to increase tax revenues, to balance the budget, should not be undertaken without an understanding of the historical perspective of the place of tax favored employer sponsored fringe benefits, and how they integrate with Government programs and personal coverages.

It is worth noting that within Owens-Illinois health care coverage is provided for all active employees, all retirees and all dependents. The level of coverage and cost to recipients is equal regardless of income or gender.

Owens-Illinois also believes that if there were no tax incentives for providing fringe benefits, a severe shrinkage of employer sponsored plans would result. While the net tax burden to companies like Owens-Illinois would remain the same, there would be significant pressure from our employees to keep them whole for the resulting additional personal tax liability on fringe benefits which heretofore have not been taxed. Employees once taxed on their employer sponsored fringes might then choose not to be covered under company benefit plans due to the inability of both meeting the added tax burden and for meeting other quality of life economic choices.

This, then, could further erode the ability of our employees to adequately provide for a portion of their own economic security and that of their dependents. Employees could purchase fringe benefits on their own. Some now do this to supplement government and employer sponsored programs. However, individual coverages are usually purchased at a much higher cost than those obtained through and on behalf of any large sponsoring group. Of course, the Federal Government could enter the benefit business. However, given the recent well publicized problems with medicare and Social Security, it also appears as if the private sector should continue, or even increase, its share of the economic security benefit burden.

Based on our unique long history of providing such benefits, I believe Owens-Illinois can continue to provide this economic security on a cost effective, nondiscriminatory basis if the appropriate tax incentives remain in place. However, it becomes virtually impossible to develop a coherent, long-range, strategic compensation plan for our employees since we are never sure which benefits will become disfavored and what after tax benefits to employees will result.

Owens-Illinois thus recommends that Congress consider a moratorium on all employer sponsored fringe benefit tax legislation until the issues are openly and freely debated and a national direction is established. Owens-Illinois would suggest that the Internal Revenue Code is neutral with respect to employer size and the ability or inability to provide fringe benefits. The fact that larger employers are able to offer a wider variety of benefits is based not on present tax policy, but on the ability of employers to obtain cost effective coverages due to the relative number of people employed. As Congress considers tax policy with respect to employer sponsored fringe benefit programs, please bear in mind the long history of tax provisions favoring the widespread development of economic security benefits, that these provisions result in full participation by all employees and the present rules ensure that all participating employees benefit fairly from the tax incentives.

Taxation of employee benefits as a revenue enhancement measure will result in a shrinkage of the employer sponsored benefit delivery system and put new and dramatic pressure on Government sponsored social welfare programs at an added cost to all taxpayers. Please do not mortgage our future to pay for the present.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mr. Williams follows:]

STATEMENT OF

OF

TIMOTHY L. WILLIAMS

DIRECTOR, HUMAN RESOURCE PLANNING

OWENS-ILLINOIS, INC.

BEFORE THE

SUBCOMMITTEE ON TAXATION

AND DEBT MANAGEMENT

OF THE

SENATE FINANCE COMMITTEE

CONCERNING

FRINGE BENEFIT TAXATION

JULY 30, 1984

SUMMARY

TIMOTHY L. WILLIAMS
DIRECTOR, HUMAN RESOURCE PLANNING, OWENS-ILLINOIS, INC.

BEFORE THE SENATE FINANCE COMMITTEE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, THE HONORABLE R. PACKWOOD, CHAIRMAN, JULY 30, 1984.

Owens-Illinois has been providing benefits for its salaried and hourly employees for over 62 years. We are a Dow-Jones "30 Industrial" company, with over 30,000 employees and 16,000 retirees, with 1983 consolidated sales of $3.4 billion. Our fringe benefit plans include health and life insurance, disability insurance, survivors' benefits retirement, and capital accumulation, at an annual cost to the company of $149.6 million.

Congress, in its wisdom, has granted tax-favored status to certain employee fringe benefit plans. This, in partnership with existing public programs such as Medicare and Social Security, and personal self-sufficiency, has formed an effective web of economic security for the vast majority of American workers.

It is our concern that, should the Congress now decide to revoke such tax-favored status for our existing plans for whatever reason (but especially if to "enhance revenue" without first thoroughly examining their place in the total benefit delivery system), serious negative consequences for Owens-Illinois and its employees will result.

We believe the employer-sponsored benefit system which has evolved through the encouragement of existing tax provisions should be allowed to continue, and even increase. The taxation of employee benefits is a reversal of long-standing tax policy and will lead to a contraction of the employer-sponsored fringe-benefit delivery system.

Taxation of employer-sponsored fringe benefits will mortgage the future to pay for the present.

STATEMENT

SENATOR PACKWOOD AND DISTINGUISHED MEMBERS OF THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT:

My name is Tim Williams, and I am Director of Human Resource Planning for Owens-Illinois, Inc. My company, with headquarters in Toledo, Ohio, employs in excess of 9,000 salaried and 24,000 hourly workers, located in 120 communities throughout the United States, with 1983 consolidated sales over $3.4 billion. Owens-Illinois is one of the world's leading and most diversified manufacturers of packaging and specialized glass products. The Company also has an investment in health care and financial services.

Owens-Illinois (or O-I) has a long and proud history of providing its employees significant economic security and wellbeing through a variety of company-sponsored benefits. We have in place, today, programs providing for health care, survivors' benefits, salary and hourly wage continuation, capital accumulation, retirement, and retiree health care and life insurance. In fact, we have been providing benefits for over 62 years; we were partners in one of the first group insurance contracts ever issued in the world. Our oldest retiree is 97 years old and has been receiving a pension check for 31 years. We have been providing retirement benefits for over 40 years. For O-I a promise made is, indeed, a promise kept.

In 1983, our total expenditures for the above fringe benefit plans was $149.6 million.

During my presentation, I will discuss the six questions posed in the press release; however, I will specifically address the third and fourth questions.

In response to Question One, the tax law should encourage employers to provide fringe benefits. Those benefits or services currently favored in the Internal Revenue Code should continue, as well as the existing type and level of tax incentives, if it remains a national commitment to provide a system of private and public economic security for workers, survivors, retirees, and their dependents.

Contemplated revisions should be analyzed in light of the social outcome of any restructuring of the Internal Revenue Code. If the objective is purely to reduce "tax expenditures" without cognizance of the broader societal goals, an incoherent and possibly dangerous, situation occurs. The rush to increase tax revenues should not be undertaken without an understanding of the historical perspective of the place of tax-favored employer-sponsored fringe benefits, and how they integrate with government programs and personal coverages.

In brief response to Number Two, if the operative word is "encourage," then more favorable tax treatment is needed without limitations, "caps," etc.

In answer to Number Three, there is currently a variety of provisions ensuring that all of O-I's employees benefit fairly from the tax incentives which govern our employee benefit plans.

Within Owens-Illinois, health care coverage is provided for <u>all</u> active employees, all retirees and all dependents. The level of coverage and cost to recipients is equal regardless of income or sex.

During 1983, the total cost for our active and retired employees in our health care programs was $72 million. Please note that of this expenditure, less than one percent, or $500,000 went to our Senior Executive group.

Survivors' benefits are provided at some multiple of active salary to all salary employees, based on the theory of income replacement to the survivors. This benefit is completely paid for by O-I.

This same theory (income replacement) is also the basis for the benefits provided under our Salary Retirement Plan, which is based on a percent of active salary with one-half primary Social Security offset, and provided at no employee cost. Our salary and hourly retirement plans cover 100% of our employees, who become participants from their first day of active full-time service. Total 1983 company contributions to the plans were $55.4 million. Annual retirement benefit payments for our hourly and salary retirees, survivors, and orphans was $73.3 million.

Our capital accumulation plan, a qualified, defined contribution 401(k) stock purchase plan with a 50% company match, is also based on a percent of salary contribution, and is offered to all salaried employees.

Existing provisions in the Internal Revenue Code are sufficient to ensure that all O-I employees benefit fairly from employer-sponsored fringe benefits. O-I's fringe benefit programs are offered to all employees, male and female. This is also true for the fringe benefit programs resulting from the collective bargaining process.

In response to Question Four, if there were no tax incentives for providing fringe benefits, it is anticipated that a severe shrinkage of employer-sponsored plans would result. While the net tax burden to companies like O-I would remain the same, there would be significant pressure from our employees to "keep them whole" for the resulting additional personal tax liability on fringe benefits which heretofore had not been taxed. Employees, once taxed on their employer-sponsored fringes might then choose not to be covered under company benefit plans due to the inability of both meeting the added tax burden and for meeting other quality-of-life economic holders. This, then, could further erode the ability of our employees to adequately provide for a portion of their own economic security and that of their dependents.

Employees could purchase fringe benefits on their own. Some now do this to supplement government and employer-sponsored programs; however, individual coverages are usually purchased at a much higher cost than those obtained through, and on behalf of, any large sponsoring group.

Of course, the Federal government could enter the benefit business. However, given the recent well-publicized problems with Medicare and Social Security, it also appears as if the private sector should continue, or even increase its share of the economic security/benefit burden.

Based on our unique long history of providing such benefits, I believe O-I can continue to provide this economic security on a cost-effective, non-discriminatory basis, if the appropriate tax incentives remain in place.

Question Five addresses the role of tax policy on compensation planning.

By revising the tax treatment of fringe benefits only as a revenue-enhancement measure, it becomes virtually impossible to develop a coherent, long-range strategic compensation plan, since we are never sure which benefits will become disfavored, and what after-tax benefit to employees will result.

In response to Question Six, the Internal Revenue Code should be, and is, neutral with respect to employer size and the ability or inability to provide fringe benefits. The fact that "larger" employers are able to offer a wider variety of benefits is based not on present tax policy, but on the ability of employers to obtain cost-effective coverages due to the relative number of people employed.

Senator Packwood and Distinguished Committee Members, thank you for affording me this opportunity to present my company's views on benefits. We do have a long history; we do provide benefits on a cost-effective, non-discriminatory basis; all of our employees participate in our plans.

As Congress considers tax policy with respect to employer-sponsored fringe benefit programs, please bear in mind the long history of tax provisions favoring the widespread development of economic security benefits, that these tax provisions resulted in full participation by all employees, and that the present rules ensure that all participating employees benefit fairly from tax incentives. The taxation of employee benefits as a revenue-enhancement measure will result in a shrinkage in the employer-sponsored benefit delivery system, and put new and dramatic pressure on government-sponsored social welfare programs, at an added cost to all taxpayers.

Do not mortgage our future to pay for our present.

Thank you.

STATEMENT OF DEAN BARD, GENERAL MANAGER, PAYROLL AND EMPLOYEE BENEFITS, MAPCO, TULSA, OK

Senator PACKWOOD. Mr. Bard.

Mr. BARD. I am Dean Bard, general manager of Payroll and Employee Benefits of MAPCO. MAPCO is an integrated energy company exploring for oil, gas, and coal, producing, refining and marketing oil and precious metals; operates the Nation's largest gas liquids and ammonia pipeline system; and producing and marketing liquid plant food. MAPCO has over 7,000,employees, which all but 140 are nonunion. MAPCO employees work in 30 States ranging from Idaho to Alaska, Louisiana and Maryland. MAPCO's costs to provide our employee benefits was in excess of $58 million in 1983. We provide our employees with a benefit package of protection. We develop and design our plan to provide security and protection against unforeseen catastrophic events or circumstances during that employee's working years.

Also, we provide benefits which the employee may accumulate during their working years to provide them with the income security they need after retirement. We also have a definite philosophy to provide benefits to those employees who have the largest exposure to catastrophic events or to those employees who have the greatest need.

MAPCO does not consider our benefits as additional compensation, but a package of protection. Throughout our employees' careers some may never receive anything from a particular benefit plan. Two examples would be our long-term disability or offtime, which is basically our sick time plan.

If the employee does not become disabled or doesn't become sick, basically no benefits would ever be received. But on the other hand, if they do become disabled, they do have something there and they have something that they can rely on. If they become disabled and cannot work, they are not solely dependent upon State or Federal government programs for their existence. For our employees, the benefits are there when and if they are needed.

Taxation of the MAPCO benefits program would be improper because an employee would be taxed for benefits that they may never receive.

We do not consider our benefits as compensation because they are strictly a protection against the loss of income; not a substitute for income. Further, the employee cannot use them as a substitute for income by picking and choosing among those benefits, what sometimes happens in flexible benefit plans electing to receive cash.

There has also been a recent discussion to tax employees on the amount of medical premiums paid by employers on behalf of the employee for the purpose of cost containment. Escalating medical costs is probably one of the most intensive subjects in the employee benefits area, much like our national problem recently with inflation. There are a number of variables causing the escalating costs, and the private sector has been working very hard to find solutions to this problem.

Briefly, our health delivery system does not operate like other sectors of our competitive, free enterprise system which normally involves a willing buyer and a willing seller. In the health care system, the employees are the consumers, the doctors and hospitals are the providers, and the insurance companies or employers are the payers. Not one of these segments alone are at fault. All three have played a role which has created the escalating cost problem.

We have and continue to make changes, hold seminars, in an effort to participate in employer health coalitions working with providers. The chief financial officer of MAPCO is a board member of one of the local hospitals. In our benefits plans, in order to encourage employee participation in this effort, we recently redesigned our medical benefits in order to promote cost containment as opposed to cost shifting which happens in flexible plans. We have increased the employees' deductibles and out of pocket exposure, eliminated coordination of benefits, which is duplicate coverage, and terminated the coverage of working spouses who have medical coverage where they work.

In summary, I would like to emphasize that not all employers are in favor of the new trend of cafeteria or flexible benefit plans. Many of us believe there is a real distinction between compensation and benefits and the Congress in most cases has wisely recognized that distinction. We believe if employers establishes and Congress blesses plans which permit income and income security to be interchanged, the legitimate distinction will be blurred; a legitimate social policy will be frustrated; and undue taxation may result. And, finally, I would ask for a 3-year moratorium on future benefits legislation. As I have stated previously, benefits have a definite purpose and the multitude of recently passed Federal legislation and regulation is causing employers to wonder if their benefit programs are worth the trouble. If you add to this the possible taxation of benefits, I would say it is not.

Thank you.

Senator PACKWOOD. Thank you, Mr. Bard.

[The Prepared Written Statement of Mr. Bard Follows:]

TESTIMONY BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE

One of the main issues that should be discussed is the philosophy of Employee Benefits and their original purpose which justifies their existence. There appears to be a new philosophy emerging changing the original definition of Employee Benefits. The MAPCO policy with regard to Empolyee Benefits has not accepted this new philosophy that Employee Benefits are compensation. In opposition to my colleagues who view Employee Benefits as only an extension of compensation, I believe that Employee Benefits provide the empolyee with protection and security as viewed from a traditional approach. Our benefits are designed in such a way that the employee does not receive benefits unless there is a catalyst which is an event that occurs to that employee or his family which entitles that empolyee to receive benefits as described by the plans. Otherwise, if the empolyee has not experienced an event which is the catalyst triggering the payment of benefits, the employee receives no economic benefit from the MAPCO program. I am currently in the process of introducing a new concept to upper management in a form of communication to our employees that would describe the MAPCO benefits as the MAPCO Package of Protection. This is opposed to Employee Benefits as a form of compensation, with an employee having the option to elect different benefits or cash. Under that scenario, he has constructive receipt of an economic benefit. Under the MAPCO Benefit Package of Protection, if the employee or the employee's family incurs medical cost, the plan pays, as specified, the medical benefits to which the employee is entitled under the plan. If an employee's family under our health plan does not incur any medical bills during the year, he is actually not receiving any economical benefit from the MAPCO medical plan.

At this point I would like to address the current discussions with regard to taxation of medical benefits as a cost containment feature to be legislated by the Congress.

Our medical plan is self-insured and self-administered, and our cost per employee is substantially below industry averages for fully insured plans. Recently, we have been very concerned with the increase in our cost of medical benefits from one year to the next. Our costs have been one-half the cost of fully insured plans, but we have also experienced twenty to twenty-five percent increases per year for the last six years.

Some employers have shifted their medical cost to other employers through cafeteria benefits by allowing their empoyees to opt out of their medical plan by giving them additional benefits in another area. An employee may have other insurance coverage available through a spouse at another employer and thus, medical costs have simply been shifted to other employers. We elect not to shift our medical costs to other employers through our plan design, but instead attack the problem directly by increasing deductibles and total out-of-pocket exposure to the employee in order to get the employee involved in the effort to control rising medical costs.

Plan design is by far the best medium for controlling cost. Some employers have failed to recognize the need to reevaluate their benefit plans to identify areas of excessive use, analyze the reason for the increase, and take the steps or measures appropriate to eliminate abuses of the plan. Since the implementation of our plan changes, our six-month cost figures for 1984 compared to the previous six months of 1983 have increased one percent, as opposed to historical twenty to twenty-five percent annual increases.

Under our basic disability plan, an employee who becomes totally disabled for a period of twenty-six weeks, is eligible to receive fifty percent of his base pay less other offsets, assuring that employee a guaranteed minimum in the event of disability. As in the other plans, if the employee does not become disabled, no benefits are received by the employee, so no taxation should result.

We also have a life insurance plan that pays survivor's benefits. The benefits are designed to assist those employees who have the need as opposed to cafeteria plans, which propose equity benefits for all employees. Our plan recognizes that employees with families composed of spouses and/or dependent children have a larger liability and exposure in the event of death than single employees. Our plan does not pay a death benefit over and above an amount for an employee's funeral expenses, nor does it pay excessive amounts into an individual's estate which would possibly go to a single employee's distant relatives who do not suffer financial loss because of the death. In the situation where the employee is married or has children, however, we provide a benefit to that family unit so that it is not destroyed financially by the death of the employee. The plan coverage is the traditional two times annual base salary for all employees. In addition, if the employee is married, a survivor benefit of forty percent of the employee's base salary is paid to the surviving spouse until that spouse reaches age 65, death, or remarriage. An additional children's benefit of ten percent is paid to the surviving spouse until the youngest child reaches age 23. As you can see, the MAPCO Benefits Package of Protection, as demonstrated by our life insurance plan, attempts to provide benefits where there is the greatest need.

In order to give the employee flexibility at his date of retirement, we provide both a defined benefit plan and defined contribution plan. We believe it is quite desirable to provide employees with both types of retirement plans, because both have a specific purpose in meeting differing retirement needs of various employees. Our basic pension retirement plan, the defined benefit plan, provides the employee with a level of replacement income relative to his final average pay. Our defined contribution plan on the other hand is a capital accumulation plan which gives the employee the flexibility to add to his monthly retirement income by converting the capital accumulation into an annuity, or if that is not necessary, to take the capital proceeds and buy a retirement home for his retirement years. Our retirement program should not be construed as current income since the employee receives no economic benefit currently. These benefits, of course, are taxed when and if they are received by the employee.

In a time when our government-administered retirement program is struggling for its own survival, I don't believe it is in the best interest of the American worker and this nation to discourage the formation and cultivation of the private retirement system.

We applaud current and past tax legislation that has encouraged employers to provide benefits to their employees under the traditional programs, where benefits are established in order to provide the employee with security and protection in the event of unforeseen circumstances such as medical expenses, long-term disability, and death, or to provide for their retirement needs. The current tax laws which allows the non-recognition of tax on the benefit accrual and the resulting non-taxation of income on assets accumulated for these benefits is very desirable from the employee's prospective, and also from that of the employer. The invested income generated by the trust to provide these benefits reduces the overall cost for the employers to provide the program. Under the MAPCO approach of providing benefits as a Package of Protection, the existing rules concerning traditional fringe benefits are sufficient to insure that all employees benefit fairly from the tax incentives that are currently part of our current Internal Revenue Code.

There are also current tax incentives provided by our Federal Statutes which allow employers to provide such benefits as day care, Section 125 Reimbursement Accounts and also Cafeteria Plans. MAPCO has not adopted these because they do not fit our philosophy of Package of Protection. These benefits, in our opinion, do provide the employee with additional tax free non-cash or cash compensation, and do not fit our philosophy of employee benefits. These expenditures are not retirement related, nor are they really protection against the unforeseen. They should be part of the employee's every day living expenditures. We see little justification, other than tax avoidance, for day care benefits or reimbursement accounts.

In recent years, some employers, either advertently or inadvertently, have blurred the distinction between benefits and compensation. We believe Congress should maintain the distinction. Clear substitutes for ordinary income should be taxed as income, but benefits which provide income security in the event of retirement or unforeseen events should not be taxed until and unless they are received.

In closing, I would like to respectfully request that Congres impose a three-year moratorium on future benefits legislation. As I stated previously, benefits have a definite purpose and the multitude of recently passed federal legislation and regulation is causing employers to wonder if their programs are worth the trouble. If you add to this the possible taxation of benefits, I would say it is not.

Finally, I have attached copies of magazine and newspaper articles I have written, and a speech I delivered at an Employee Benefits Seminar in Stanford, Connecticut, April 20, 1983.

MAPCO is an integrated energy company exploring for oil, gas and coal; producing, refining and marketing oil, and precious metals; operating the nation's largest gas liquids and ammonia pipeline system; and producing and marketing liquid plant foods. MAPCO has over 6,750 employees of which all but 140 are nonunion. MAPCO employees work in thirty states ranging from Idaho to Alaska to Louisiana, and Maryland. MAPCO's cost to provide our employees their benefits was in excess of $58 million for 1983.

Flexible Benefits—New Directions, the Unanswered Questions

(by Dean Bard, Stamford, CT)

I would like to recognize the other speakers today on their commendable presentations. They have given you a lot of food for thought. I have been asked to speak to you today on Flexible Benefits from possibly a different perspective than what has been discussed previously. I am not addressing 125 Flexible Spending Accounts, but converting existing benefits to flexible benefits. There appears to be a certain change in general definition of what are employee benefits. I would like to present to you what I believe you should consider and questions you should ask yourself before implementing a Flexible Benefit plan. It is my belief that employee benefits were first implemented into the corporate structure to give the employee peace of mind in the event of unforeseen circumstances. For example, medical insurance was provided by an employer on a group rate basis because medical expenses even years ago were more costly that what the normal average family could afford to pay without the coverage of some type of insurance. Then the employee benefits field continued to expand to include such catastrophic or unexpected circumstances which could occur such as death of the employee, short term disability and long term disability. Also, retirement programs were implemented to assist the employee in providing supplemental monthly income after his/her productive years.

Today, there seems to be a new wave of what are employee benefits. Flexible Benefits proponents state that employee benefits are additional compensation. This is a question I believe you must ask yourself. Are employee benefits additional compensation or are employee benefits put into place in order to give that employee in addition to their salary a certain level of confidence and assurance that if something occurs that is catastrophic this event will be taken care of under the employee benefit plans. This major change in philosophy of what employee benefits are has a major impact on what your basic corporate goal is that your trying to accomplish for your employees. I believe such benefit plans such as short term disability or sick pay was originally instituted in order to take care of that employee in the event they become sick or disabled. What has transpired through employee perception is that a short term disability plan has become to be viewed as a inherit right to be received regardless if the employee is sick or not. I support the philosophy that employee benefits basically were instituted in order to give that employee a comfort level to handle problems when they occur and they were not instituted to give the employee additional compensation. The main problem with conventional benefits is the lack of proper communication of what the employee benefit plans purpose was when it was implemented.

If you accept the traditional philosophy of what employee benefits are your problem is not in trying to redevelop your employee benefit program and change its basic philosophy, but to communicate to your employees why these benefits were put into place. Flexible Benefits proponents have stated how the demographic makeup of the American worker today has changed, what employee benefits are, and how they should be structured. This view supports that employee benefits are additional compensation and a single employee is entitled to as much of these employee benefits as the married employee with 2 or 3 children. Under the traditional approach the company looks at the employee benefits as protection for those employees who have additional liability, and exposure to catastrophic events, and if a single employee under a life plan for example dies should the Company pay out dollars under a life insurance plan to a mother or father. The MAPCO life insurance plan was designed to pay two times the annual base salary and double indemnity in the event of Accidental Death off the job for all employees which gives a certain level of confidence that certain financial obligations of that individual will be taken care of if that employee dies. But, in addition, the MAPCO life insurance plan if you are married, pays a monthly survivor benefit to the surviving spouse and an additional monthly benefit to the spouse for the benefit of their children. This plan was implemented so that in the event of death of the employee who was married with children that the family unit would not be required to sell family assets and the life style of that family would not be completely destroyed because of death of the employee. Traditionally single employees benefit costs are not as high as the married employee with dependents. Flexibility for married employees reduces benefits if total costs are maintained.

My next concern regarding Flexible Benefits is adverse selection. Proponents state that adverse selection can be taken care of through careful flexible benefit plan design. My experience with employee benefit plan design even in the traditional approach is very difficult. I'm sure you have implemented a new benefit plan or change thinking all the bases were covered. Afterwards, there are employee situations which you would have never considered, and that situation doesn't quite fit your basic intention of the plan. And with a flexible benefit plan that problem is magnified tremendously by the multiple options an employee can elect. It is my opinion after a period of years of a flexible benefit plan that the employee would have figured out virtually every angle of a flexible benefit plan which will adversely affect the cost previously anticipated by the Company.

It has been said also in other articles that flexible benefits help the employer control the cost of employee benefits. In the articles that I read this is to be done on the basis that flexible dollars will be fixed. In the event the employee benefit cost increased it is up to the employer to decide whether to raise the amount allocated to employees in flexible dollars. In this way the employer is able to control its costs. Let's assume in the year one the employee has $2,000 to allocate to his flexible plan and he allocates those benefits in such a manner that gets his benefit plans designed to what he prefers. Let's assume that employee benefit costs in total for the next two years increase to $2,400 per employee. The employer decides not to raise the employee's benefit dollar allocation from the $2,000 to the $2,400. At this stage, the employee has now suffered a benefit reduction under a flexible benefit arrangement where he wouldn't have experienced this reduction under a traditional approach. The employee must also re-evaluate his position and possibly adjust his benefits in order to achieve the desired protection under particular coverages. In my opinion, this indirect benefit reduction will create adverse employee attitude toward the company and the benefit program. I believe it is very important today to retain the employee's confidence by demonstrating that the employer is honest, straight forward and direct and does not do things under the table. By reducing benefits under a traditional concept if needed and through proper communications an explanation of why changes are made, the majority of the employees can understand what you're doing, and why you're doing it. You must be direct, to the point, and tell them the straight facts which I feel will be very much appreciated by your employees in that it was not done on the basis of an under the table or behind the back reduction of their benefits.

If the employer decides to increase the flexible benefits in order to keep his benefit package in line and competitive with other employers plans who are using a traditional benefit approach, he will be required to increase those flexible dollars in order to maintain that competitive position. The traditional benefit plans will be experiencing cost increased in benefits and the Company will absorb those increases until they change the plans and reduce benefits directly. So I contend that flexible benefits do not control cost anymore than a traditional plan except on the basis if an employer does attempt to control costs by reducing benefits to that employee indirectly.

Another concern I nave regarding flexible benefits is the governments perception of employee benefits as a tax free deferred benefit which is another of the major reasons why employee benefits came about in the beginning. If employee benefits are taxed in total, why should an employer have employee benefits when the alternative could be to increase his salary and let him spend his dollars where he wants to. This approach is the ultimate flexible benefit plan. My major concern in this area was addressed in a recent

BUSINESS INSURANCE ARTICLE

Under flexible benefits the employee can pick and choose the types of "compensation" he would like to receive and the government at that time could very easily defend the position that the employee now is receiving additional compensation other than salary which should be recognized as current taxable income. The employee will lose one of the biggest benefits he currently enjoys under traditional plans of those benefits being received tax free. I believe we stand a better chance of deferring this taxation under a traditional benefit program.

Another concern I have with regard to flexible benefits is most benefits today are being implemented with a core of benefits in order to protect the employee under the traditional approach and carving off a top piece in order to create the flexible dollar bank for the employee. Once these plans are implemented, there could be additional employee pressure to make the entire benefit program flexible. It would be my view if you as an employer believe I should have the flexibility to pick and choose my compensation in a manner to fit my personal situation, that I should be able to do this in total and I should not be restricted. I've become very concerned at this point on the basis of an employee making an election to opt out of all benefit plans (which could very well be my choice) and take all flexible benefit dollars allocated to me toward a defined contribution plan. The amounts in that defined contribution plan could then subsequently be used for all benefit purposes that the employee may need i.e. short term disability, vacation, holidays, LTD. After a period of time, the employee should have a substantial sum of money built up in a defined contribution plan to handle the multitude of events that could occur or happen as long as one of these events does not occur early in their carrer. At the time of election, he/she would be making the choice and gamble that they are in good health, their family is in good health, nothing is going to occur to them or their family in the near term, they will have good experience, they will beat the the norm and will come out ahead in the long run. One basic problem with this approach is what happens if the employee's wrong. For example the employee works for five years and is killed in a automobile accident, his wife and three children are left with virtually nothing. How is the company going to be viewed in this situation that allowed the employee to get himself in this position. And who is going to be called upon to take care of this poor family that the employer neglected his responsibility to protect that employee in the case of an unforeseen catastrophic event.

INTER-COMPANY COST SHIFTING AND MEDICAL COSTS

In summary before implementing a flexible benefit plan please consider:

(1) What are Employee Benefits? Compensation or Employee peace of mind and "Security".

(2) What is your company's philosophy with regard to benefits? To provide security or additional compensation.

(3) Communicate your company philosophy to your employees.

(4) Can plan design actually handle adverse selection in a flexible plan over a long period of time?

(5) Benefit cost control. If you want to control costs by benefit reduction do you do it directly or indirectly. If it's done indirectly you may create bad employee relations.

(6) How will the government's attitude toward the non-taxable status of employee benefits be affected?

(7) If a company is pressured into total flexibility of the plans and an employee chooses the wrong coverage and is subsequently adversely affected by his decision will it ultimately be the companies fault.

(8) Inter-company cost shifting of medical costs.

(9) Very expensive.

[From Business Insurance, Mar. 14, 1983]

TAX WOULD CURB APPEAL OF FLEXIBLE BENEFITS

(By Jerry Geisel)

WASHINGTON.—Congress' proposal to impose Social Security taxes on flexible benefits plans will diminish the appeal of the fast-growing plans and cost employers more, benefit experts say.

The House of Representatives last week approved Social Security bailout legislation that imposes FICA payroll taxes on cafeteria-style benefit plans that give employees a choice of tax-free benefits and cash.

Under the legislation, H.R. 1900, which is now pending in the Senate, cafeteria plans would be subject to Social Security taxes if the menu of benefits from which employees can chose includes cash or any other taxable benefits.

For example, if a cafeteria plan offered an employee a choice of family health insurance coverage or $500, the employee's taxable wage base would be increased by $500—even if the employee selected the health insurance benefit.

By contrast, under current tax law, employees enrolled in cafeteria plans only pay taxes if they select a taxable benefit.

While the proposed legislation states that any cash or other taxable benefit offered in a flexible benefit plan would be subject to the FICA taxes, other taxable benefits besides cash are seldom included. If they were, the amount the company spent on those benefits also would be figured into the taxable income.

The proposed taxation of cafeteria benefit plans would diminish the appeal of the fast-growing cafeteria plans, experts say.

For employers, the cost of the plans would increase, too. Companies would have to pay Social Security taxes on the taxable benefits, which could cost large employers hundreds of thousands of dollars.

For example, if the average employee's taxable wage base were increased by $200 because of taxable flexible benefit plan options, a 10,000-employee company would find its Social Security costs rising by $140,000, assuming the FICA tax next year rises to 7% of the payroll from the current 6.7%.

At the same time, employees' take-home pay would be reduced since they would pay more Social Security taxes.

"This will increase the cost of employee benefits," said Sylvester Schieber, director of research at the Employee Benefit Research Institute, a Washington-based benefits think tank.

Employers, though, could avoid the increased FICA tax by eliminating any taxable benefit options from flexible plans, said Bob Wallace, a consultant and actuary with Buck Consultants Inc. in New York.

For example, they could just offer tax-free options like health insurance, vision care and dental coverage and not cash.

However, this might reduce the appeal of the plans. The freedom to choose cash in lieu of benefits is especially attractive to young workers who may need the money to meet hefty mortgage payments.

"Flexible benefit plans will survive, but their appeal will be diminished," said William Chip, a Washington attorney with Ivins, Phillips & Barker, which represents the Employers Council on Flexible Compensation.

"Most companies won't offer a cash option," Mr. Chip added.

Benefit experts say there are broad implications in the House's decision to impose new taxes on cafeteria plans.

"Congress is changing its definition on what is taxable compensation," said Jim Waters, a vp with Towers, Perrin, Forster & Crosby in New York. Legislators are now considering benefits—not just salary—as part of the taxable wage base, Mr. Waters adds.

"This is a foot in the benefits taxing door," said Lloyd Kaye, a principal at William M. Mercer Inc. in New York. "Once Congress starts, no one knows where they will stop. That is what is most alarming."

As a matter of fact, the Social Security bill also proposes taxing up to half of Social Security benefits for middle-class and well-to-retirees and would make wages deferred under 401(k) salary reduction plans subject to FICA taxes, too.

However, in contrast to the proposals to tax 401(k) contributions and Social Security benefits, the cafeteria benefits tax never was discussed or analyzed when the House Ways and Means Committee held hearings on the entire Social Security bill. It was added just prior to the committee vote.

"Increasingly, the real legislation is not presented until the hearings are over. This was done behind the scenes," one lobbyist said.

There was little time for employers to do much," said Mr. Chip of the Employers Council on Flexible Compensation, which is now lobbying fiercely against the proposal to subject flexible benefits to the FICA tax.

But the lobbying effort faces tough odds. In the coming months, the attention of legislators and their aides will be foscused on other parts of the Social Security bill that affect many more people, like higher payroll taxes and mandatory Social Security coverage for non-profit and new federal employees.

"I would think it (taxing cafeteria benfits) would pass. I doubt if corporate objections will carry the day," predicts Mercer's Mr. Kaye.

In passing the Social Security legislation on a 282-148 vote, Congress also agreed to gradually raise the Social Security retirement age until it reaches 67 by 2027. It is now 65.

Other provisions it the bill include:

Social Security payroll tax increases for employers and employees would be accelerated. On Jan. 1, 1984, the tax would rise to 7% from 6.7%. Next year's 0.3% increase for employees, however, would be offset by an income tax credit.

In addition, FICA taxes would continue to raise slightly ahead of schedule after 1984. For example, in 1988, the tax would climb to 7.51% instead of the planned 7.15%. The payroll tax would hit 7.65%, as scheduled, in 1990.

The self-employed, who now pay about three-fourths of the combined employee-employer FICA tax rate of 13.4%, would pay the full rate, which would be 14% in 1984. However, the self-employed could deduct 50% of the combined rate on their federal income taxes as a business expense.

Non-profit employers, including those that have already withdrawn from Social Security, would have to participate in the program by Jan. 1, 1984. In addition, workers hired by the federal government after Jan. 1, 1984, would be covered under Social Security.

Local and state governments could not opt out of Social Security after the legislation's effective date. However, public employers that already have withdrawn would not have to return.

The next hike in cost-of-living benefit increases, now scheduled for July 1, would be delayed until Jan. 1, 1984. All future COLA adjustments would be made on Jan. 1.

Social Security benefits would be taxed for retirees whose incomes exceed certain levels. The tax would be phased in for individuals whose adjusted gross incomes exceed $25,000; for married couples, the tax trigger would be $32,000.

CIGNA Offers Grants

New York.—CIGNA Corp. said last week that it has set up a $1 million grant program to help local business coalitions battle soaring health care costs.

Under the program, grants ranging from $5,000 to $50,000 will be awarded to coalitions for specific health care cost-containment projects.

CIGNA said it is especially interested in the creation and use of health cost data bases by business coalitions, so employers can track health care utilization at facilities in their area.

[From Benefits News Analysis, January 1983]

COPING WITH INTER-COMPANY COST SHIFTING

(By Dean Bard)

(How flexible benefits employers are taking advantage of dependent medical benefits provided by companies with conventional programs. MAPCO, Inc. takes the lead in self protection.)

Flexible benefits programs now adopted by numerous companies are causing employers with conventional programs to become concerned about the problem of inter-company cost-shifting in medical coverage.

Inter-company cost-shifting is not new, nor is it brought about by flexible benefits alone. Employers with contributory medical plans have previously been a problem for those with non-contributory programs because employees with working spouses have generally opted out of contributory medical coverages, leaving the non-contributory employer covering both employee and dependent. In the past, companies have accepted this type of cost-shifting as unintentional. But with the advent of flexible benefits, a number of employers have deliberately designed their programs to take maximum advantage of their employees' spouse coverages.

When a company implements a flexible program, it usually offers employees the opportunity to elect less expensive benefits or "opt out" of medical coverages altogether. If the employee's spouse is working and has dependent medical coverage from his or her employer, the flexible benefits employee is often better off opting out of both employee and dependent medical coverage (taking coverage under the spouse's employer's plan), and spending the available "flexdollars" on other options.

While this may sound good to the employee and beneficial to the flexible benefits employer, the company with conventional benefits ends up paying for all the medical benefits liabilities for that family. And, as more companies go "flexible," conventional-program employers may be picking up the tab for a significant number of "free-loaders." With the cost of dependent medical coverage being much higher than employee coverage, and with escalating health care costs in general, the impact of "free-loaders" on a company's medical benefits costs can be substantial—estimated from a few hundred dollars to as much as $1000 annually per employee.

Observers believe a number of employers are exploring ways to protect themselves from potential inter-company cost-shifting. Many are rethinking their medical benefits design and questioning fundamental and well-established concepts such as coordination of benefits. Some companies are considering implementing their own flexible benefits programs as a defensive measure. But a few are taking a more direct approach to the problem. One such company is MAPCO, Inc. in Tulsa, Oklahoma. In an interview with *Benefits News Analysis*, Dean Bard, MAPCO's General Manager-Payroll and Employee Benefits, discussed the measures his company has taken to cope with the cost-shifting problem.

NO COVERAGE FOR INSURED SPOUSES

The company provides its employees with non-contributory, full-service medical benefits coverage, and like many other employers, has been willing to cover dependents regardless of where the spouse was employed (subject to coordination of benefits limits). But recently the company became concerned that other employers might be taking advantage of MAPCO's generous benefits program—directly, through flexible benefits, or indirectly, by having contributory plans, or by offering inferior medical coverage.

"We did not want other employers to relieve themselves of a portion of their medical benefits liability and put that burden on MAPCO," said Bard. "Employers, for understandable reasons, are trying to cut their health care benefits costs. We are trying to do the same thing, but we don't want to do that by shifting our costs to other employers. And at the same time, we don't want to pick up liabilities that should not be ours."

Effective January 1, 1983, MAPCO will not provide spouse medical coverage for employees' spouses whose employers offer a medical benefits program. The company will, however, continue to cover dependent children, and will also cover all of the employee's dependents if the spouse is unemployed or employed by a company which does not provide medical benefits.

Coordination of benefits in the case of spouse coverage will no longer be applied if another employer's plan is primary. This decision will effectively solve the problems which might arise if a spouse chose a flexible benefits option with a large deductible or less coverage. "We will not make up the difference between the two plans' coverages," Bard stated. "We will not subsidize other employer's benefits that are lesser than ours."

The problem still exists in the case of dependent children. For example, a male MAPCO employee with a working wife has coverage for his children from both employers. But according to coordination of benefits practices, his employer's plan is primary and that of his wife's employer is secondary. MAPCO has considered altering coordination of benefits provisions in its plans to pay only for its share of children's coverage (i.e., 50% only), but has decided not to do that pending further study.

MAPCO is self-insured and self-administered. The company has recently purchased and implemented Erisco's Claimfacts system. "We intend to use the system to enforce and track the impact of the medical plan changes," noted Bard. MAPCO's claim examiners will make inquiries during normal claims processing about the spouse's employment and availability of coverage and will also verify the information where necessary.

While no statistics have been kept in the past on the number of spouses covered under MAPCO's plan who had insurance available elsewhere, Bard said, "The phones have rung off the wall since we made the announcement December 10—in some areas, we estimate 50–75% of the workforce have spouses working somewhere else."

CATASTROPHIC COVERAGE CONCEPT

Although MAPCO's plan will remain non-contributory, coverage deductibles have been changed from individual/family to family only. Rather than raising individual deductibles, or applying per-claim, per-hospitalization or perillness deductibles as other companies have done, the company reasoned that an increased family unit deductible would stabilize total medical costs.

"We eliminated COB to get back to the concept of a catastrophic coverage plan," Bard noted. "With the deductible change, the maximum out-of-pocket for a family under MAPCO's plan is $1,380 per year."

AN END TO THE FREE RIDE

Communications about the new medical benefits were mailed to evrey employee in early December, 1982, and employees were encouraged to discuss their questions with supervisors. Supervisors referred questions they couldn't answer to benefits personnel via phone, or, when requested, Bard traveled to specific locations to make a presentation to employees.

Reaction, though initially vocal, has become calmer since the announcement, Bard stated. "Employees were very concerned at first, but after we explained the underlying factors and they saw how MAPCO was paying for other employers' liability, a vast majority accepted our action," he remarked. "Typical response ranged from, 'we knew this was going on, and wondered when you were going to catch it,' to the employee who said, 'it's the end of the free ride, isn't it?' They're not thrilled about it—but they understand and recognize why it had to be done."

Coordination of benefits and intercompany cost-shifting are issues flexible benefits proponents tend to avoid. Little or no attention has been given in the past to the impact of flexible benefits on other employers' plans, particularly by consultants who are anxious to cash in on the flexible benefits services market now estimated at over 20 million dollars a year.

Bard feels that despite all the talk about the advantages of employee choice which flexible programs bring, the only tangible advantage seems to be a financial one through shifting of medical costs to other employers.

The MAPCO initiative represents a significant development in health care benefits design that is likely to prompt other employers to examine their own programs' costs and assess the impact of coordination of benefits on such costs. Bard believes coordination of benefits defeats some of the cost controls built into medical plans by providing employees with 100% coverage. "That's what coordination of benefits is all about," he added. And when employees don't share the cost, medical benefits costs skyrocket.

[From the Tulsa (OK) Tribune, Sept. 27, 1983]

EMPLOYEES CHOOSING BENEFITS: PLAN WOULD MATCH BENEFITS, NEEDS

(Stories by Mark Davis)

When Marsha Fowler changed jobs recently, her new boss didn't tell her what kind of fringe benefits she would get. Her boss asked what kind Fowler wanted.

Fowler was able to choose her benefits under what is called a flexible benefits plan—a concept developing at some of Tulsa's larger employer's.

Traditionally, all employees of a company receive the same package of insurance and other benefits. Only the amount of coverage or value of the benefits varies.

But a flexible benefit plan allows employees—including the rank and file—to pick and choose among different amounts and kinds of benefits.

One of Tulsa's pioneer firms in flexible benefits in Bank of Oklahoma, which hired Fowler Aug. 1.

When most people get a new job, they automatically receive a basic package of benefits. So did Fowler.

Her basic package included life insurance equal to half her salary, long-term disability insurance, sick leave and short-term disability insurance, plus a retirement plan.

But because she works at BOk. Fowler also received Benepay—the bank's name for flexible benefit credits. Every employee gets a set amount of Benepay, plus an amount based on salary. The employ then uses the Benepay to "buy" the kind of insurance or other benefits desired.

For example, Fowler, who received Benepay prorated to her four months of 1983 employment, used her Benepay for medical and dental insurance. Soon she'll have to decide how to allocate her full year benefits for 1984.

Other employees at the bank have chosen other options which include a medical reimbursement plan, lower medical deductibles, day care for children, increased life and disability insurance and a thrift plan.

Bank of Oklahoma, which began its flexible benefits plan in October 1982, is one of a few Tulsa companies that have such plans in operation. Several others are looking at the option.

But flexible benefit plans aren't readily available to employees of smaller firms. The costs of developing a plan are too great to justify a program for fewer than 100 people, say Robert Hamilton, a senior consultant with A.S. Hansen Inc.

Hansen has its own flexible benefits plan and consults other firms in developing similar plans.

Hamilton says pioneering work at the larger employers may result in prototype plans that could be marketed to smaller employers at reduced costs.

The larger employers are working on two types of flexible benefits plans. Some firms, like BOk, reduce standard benefits to some minimum core and allow employees to "buy" additional benefits with special benefit credits.

Other firms set up reimbursement accounts which buy insurance or other items requested by employees and then deduct the cost from the individual's paycheck. These plans also are called reduction of salary and cafeteria plans.

A chief advantage of the reimbursement plan is its tax break. Because the benefit is deducted directly from wages, it lowers the amount of wages subject to Social Security and other withholding taxes. It also allows the employee to forgo benefits and take all his compensation in cash.

However, the Internal Revenue Service has not formally approved the tax-avoiding reimbursement plans and there's a move in Congress to tax such benefits.

"Whether this is a candy store the IRS is going to close is anybody's guess," Hamilton says.

As a result, the minimum core plan has received more attention from employers.

Thomas Graham, senior vice president of Bank of Oklahoma's human resources division, cites several advantages to its flexible benefits plan.

Employees are better informed about the kinds and costs of the benefits they receive, Graham says.

"I think before, employees tended to take benefits for granted," Graham says.

The flexible plan requires employees to allocate their Benepay among various benefits. Now they are better educated as to what different benefits cost and "how they can influence the costs, especially in the medical area," Graham adds.

Graham also says the plan makes the bank more competitive in the job market and allows easy adaptation to future changes. For example, the bank could add benefits to the selections available.

Some plans allow employees to buy additional days of sick leave. Some allow new employees to buy their way into benefit plans before they are technically eligible. Others allow employees to cash in vacation days and work for extra pay.

YOUNG CHILDREN CAR VICTIMS

Motor vehicle accidents are the leading killer and crippler of young children, causing some 650 deaths and 5,000 serious injuries a year.

FLEXIBLE PROGRAMS HAVE DRAWBACKS

A new idea sounded like a better idea—until Mapco's Dean Bard had his say.

Until Bard spoke up, many employers had heard only good news about a new concept in employee benefit plans. Bard says some of the employers he addressed in New York this spring admitted his arguments made them think twice about flexible employee benefits plans.

Flexible benefits plans allow employees to choose among a selection of medical, insurance and other benefits. Traditional benefit plans provide standard packages for all employees.

Some employers have gone to flexible benefits because employees become more involved in, and better informed about, their benefits. Employers also cite cost and tax advantages.

But the jury is not unanimous.

Bard, general manager of Mapco's payroll and employee benefits, voiced reservations about the move to flexible employee benefits. Bard says the plans:

Make it easier for a revenue-hungry Congress to tax employee benefits.

Often dump the cost of some benefits onto employers without flexible plans.

Allow employees to take advantage of the plan through "adverse selection" of benefits.

May reduce employees' benefits over a number of years without employees knowing about it.

Chief among Bard's concerns are the possible tax consequences of flexible benefit plans.

"The best part of the benefits now is that they're non-taxable benefits," Bard says.

Benefits are tax-exempt largely because Congress and the Internal Revenue Service have trouble showing how much benefits are worth, Bard says. For example, if an employee files no claims on his employers medical plan, IRS has a hard time proving he has benefited a certain number of dollars, Bard explains.

But flexible benefits plans often give employees a set dollar amount in credits to "buy" a selection of benefits. Some even allow employees to opt for cash.

Armed with a dollar value on each employee's benefits, IRS and Congress won't have any difficulty applying a tax to those benefits, Bard claims.

Congress already has initiated legislation to tax a certain kind of flexible benefits plan called a cafeteria plan. Cafeteria plans allow employees to opt for cash instead of benefits.

For example, the plan may offer employees medical insurance for one year or $500. Proposed legislation would tax the employee for $500 of additional income—even if he took the medical insurance.

"People in the flexible benefit industry are just asking for it," Bard cautions.

Bard also says flexible benefit plans exacerbate a problem called inter-company cost shifting.

An example is when an employee forgoes medical coverage offered in a flexible plan and signs up under his spouse's plan as a dependent.

The employer with flexible benefits can claim a cost reduction, but Bard says it has only forced the spouse's employer to bear the cost of insuring the other company's employee.

"It's not cost control, it's dumping it on somebody else," Bard objects.

To ward off inter-company cost shifting, Mapco disallows medical coverage to employees' spouses who have similar benefits where they work.

Bard also explained "adverse selection," a danger to the employer offering flexible benefit plans.

Because employees often can change their benefit package each year, they can load up on, say percenrt dental insurance one year and get all of their expensive bridge work or root canals paid. The next year they could take minimal dental coverage and load up on vision care benefits and get new glasses or contact lenses.

Bard concedes there are ways to design programs to avoid adverse selection, "but it's going to eat you alive over time."

Employees face a danger under flexible benefit plans, if the coverage doesn't keep up with inflation, especially in medical care costs.

Traditional plans usually guarantee some level of benefits, regardless of the price. But a flexible benefits plan guarantees only a dollar value of benefits.

If prices for the benefits increase over time, an employee would not be able to buy the same benefits without a benefit pay increase, Bard explains.

"To me you lose employee confidence in the company," Bard says.

Employees would lose confidence because they would lose benefits "through the back door" instead of having the company explain it must reduce benefits, Bard says.

Senator PACKWOOD. I don't have any questions of the two of you. I'm not sure there are any questions left to be asked.

Mr. BARD. May I answer for the record—Senator Danforth left, and he was referring to the cost of benefits increasing. And, basically, we have increased some of the benefits, but overall employee benefits have not increased except for the figures with regard to medical, as some of the previous panel members answered And the reason being is that pension plan, profit sharing, LTD, which is long-term disability, short-term disability, vacations, holidays, life insurance—these are all functions of employees' payroll. Pension plans are operated off their salary. Vacation is, a portion of his salary. Life insurance is two times the annual salary of an employee basically. So these are all functions of salary and they will increase, but they will increase at the rate that they have salary increases. Other benefit increase that has occurred is basically medical. The cost of benefit changes we have made with getting the employee more involved, we were estimating in medical costs from 20 to 25 percent a year. For the first 6 months of 1984, as compared to six months in 1983, our medical costs only increased 1 percent.

Thank you.

Senator PACKWOOD. My hunch is that 5 years from now if that same question is asked about medical, costs will not have gone up as fast as wages because you are going to see a difference in the administration of plans.

Mr. BARD. Everyone seems to be wanting to point a finger. But I think the employee and employer and provider coalitions that we are getting into we are all starting to recognize that the providers provide services and that they have been gouging the system. Employees have been getting the services and not paying for these. The employers have been paying for those services and that was during a time when we had the money to do so. So we have all created benefits that were so generous that we encouraged this escalating cost. Now it is time to take care of that problem.

Senator PACKWOOD. Gentlemen, thank you. And that will conclude our hearings.

(Whereupon, at 1:16 p.m., the hearing was concluded.)