

THE ECONOMIC EFFECTS OF SECTION 89

**Statement by
Norman B. Ture, President
Institute for Research on the Economics of Taxation
to the
Committee on Small Business
House of Representatives
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Mr. Chairman, members of the Committee, I am happy to have the opportunity to present to you my views about Section 89 of the Internal Revenue Code. My discussion focuses on the economic and tax policy issues raised by this provision of the tax law, rather than on the technical tax details.

Overview

The objective ostensibly sought by Section 89 is to reduce, if not eliminate, discrimination in employer-provided fringe benefits in employees' compensation packages. The concern, presumably, is that higher-paid employees are afforded more valuable fringe benefits as compensation components than are lower-paid employees and that this differentiation by compensation level is unfair, hence should not be condoned by tax provisions.

At issue in reconsidering this provision of the tax law is whether the legislation effectively pursues an appropriately conceived fairness goal and what costs Section 89 imposes in pursuit of this goal.

Does Section 89 Pursue the Right Objective?

Section 89's objective, if I have properly identified it, badly misses the mark. In essence, the provision identifies fairness as requiring all employees to have the same kind and amount of certain compensation elements, primarily health and life insurance, included in their pay packages, irrespective of the preferences of the employees and irrespective of what other pay components they must forgo as a result. In brief, this sort of "fairness" requires the sacrifice of employees' freedom of choice and imposes severe constraints on the choices available to them. Section 89 mistakes sameness for fairness, and in its implementation it will most harshly treat employees in the weakest economic situation, ostensibly those for whom it sought to provide fairer treatment.

The least reasonable assumption one could make about any employer's work force is that all of its members prefer to be compensated in the identical way. The U.S. economy is extraordinarily diverse, relying on an enormous variety and range of work skills and employing individuals of greatly differing backgrounds, family responsibilities, and economic circumstances. In this economy, efficient compensation policies call for diversification of the pay package to the greatest feasible extent in order best to conform each individual's pay package as closely as possible to his or her preferences and perceived needs.

There is obvious economic pressure on the employer to offer differing pay packages to differing groups of employees. Compensation packages must be acceptable to both the employer and employee. For the employer, the cost of the pay package cannot very long exceed the employee's contribution to the value of the business's output; neither can the value of the pay package to the employee fall short of the amount he or she insists on to take and keep a specific job. If an employee deems a specific fringe benefit included in the pay package to be of little or no value, the value of the other elements of compensation must be sufficient to equal the employee's reservation price for the job. The more nearly uniform is the composition of employees' compensation packages, the greater is the number of employees who are likely to be dissatisfied with a pay package of any given cost to the employer. For this reason, requiring uniformity of compensation elements is certain to exert upward pressure on compensation costs.

This fact accounts in very large part for the growing efforts by employers, at least until enactment of the Tax Reform Act of 1986, to diversify compensation arrangements by offering so-called "cafeteria plans" for fringe benefits. Allowing employees some freedom to choose among pay components, subject to given limits on the total cost to the employer, clearly enhances the efficiency of compensation. It rewards employees for their labor services in a way that best meets their demands at the

lowest cost to the employer. As such, diversified compensation contributes to expansion of employment opportunities for a wider range of employees than otherwise would be the case.

There is, of course, a significant constraint on the extent to which any employer can fine tune compensation arrangements. As a result, the composition of few, if any, employees' pay packages conforms perfectly with their preferences. Nonetheless, market forces impel virtually all employers to balance the administrative costs of adjusting the pay package as closely as possible to each employee's preferences against the savings in total compensation costs that may be realized by doing so.

Section 89 appears to disregard these elementary facts about the market for labor services in the American economy or to assume that the obvious differences in employees' circumstances and preferences have no weight in their or their employers' decisions about the best compensation program. The pressure for uniformity of the pay package exerted by Section 89 is an affront to fairness, unless one can conceive of a concept of fairness in which the preferences of the persons involved are ignored.

Section 89, in effect, asserts that employees' preferences about how they get paid is not and should not be a consideration in determining the appropriate tax treatment of fringe benefits. This kind of elitism is completely inconsistent with any meaningful concept of fairness.

Perhaps the confusion between sameness and fairness is too subtle a matter to weigh heavily in tax policy making, but surely Section 89's gross discrimination against those employees at the lowest rungs of the employment ladder should not escape policy makers' attention. One important adverse effect of Section 89 is likely to be a sharp curtailment of job opportunities for teenagers and other persons whose labor-force participation is effectively limited to part-time employment. Full-time employees with poor job skills are also likely to find themselves in a more fragile employment situation.

For purposes of determining compliance with Section 89, part-time employees working more than 17.5 hours a week must be included in the work force. In the usual case, part-time employees are not covered by group health and life insurance programs. Most often, part-time employees are not highly skilled or highly paid; for such employees, the monthly premiums for even quite skimpy health insurance plans would represent an inordinately large fraction of the employees' gross compensation. If meeting Section 89 compliance tests calls for extending health insurance to these part-time employees, their employment possibilities are likely to be severely curtailed.

For one thing, Section 89 may very well create a strong incentive for employers to alter their hiring practices to limit part-time employment to less than 17.5 hours of work per week. Part-timers working more than 17.5 hours a week may well find

themselves under pressure to accept fewer hours of work per week, hence less income, possibly facing the need to find more than one part-time job. In some cases, it might be feasible to extend the insurance coverage to these employees, but only at the cost to them of significant cuts in other elements, primarily cash wages, of their pay package.

In many cases, adjustment of the pay package may not be a realistic possibility. Consider, for example, an employee working 20 hours a week at a cash wage of, say, \$5.00 an hour. Suppose his employer's health insurance plan premium is as low as, say, \$100 a month. If required to include this employee in the health insurance plan, the employer would be faced with a 24 percent increase in the employee's gross compensation (assuming a 50-week work year). Since nothing in these circumstances increases the employee's productivity, certainly not by anything like this amount, the employee is likely to find himself looking for another job. Alternatively, the employee could take a 24 percent cut in cash wages, from \$5000 a year to \$3800. There are not likely to be many circumstances in which this is a viable option for persons in this situation.

The problem may be only slightly less severe in the case of full-time but low-paid employees. Some, possibly a substantial number of such employees, may chose cash wages in lieu of health insurance coverage when this option is available to them. Facing the requirement for extending coverage to these employees, the

employer is likely to find the cost of employing them increased on the order of, say, 10 percent, possibly a good deal more. Any such increase in employment cost will certainly jeopardize the continued employment of these employees. Alternatively, these employees may find themselves facing a cash wage reduction of a similar magnitude.

It must be clear that Section 89 creates a much more precarious employment situation for low-wage full-time and part-time employees. It is difficult to conceive any standard of fairness that validates this sort of discrimination.

What Does Section 89 Cost?

Section 89 not only misidentifies fairness in employee compensation, it also exerts upward pressure on the cost of employment throughout the American economy. For one thing, employers will incur significant costs in determining whether the fringe benefits included in their compensation packages satisfy the plan qualification and nondiscrimination employee eligibility and benefits tests that Section 89 prescribes. For another, the adjustments in compensation packages that many employers will have to make will raise their costs of providing satisfactory compensation arrangements. In important respects Section 89 is equivalent to the imposition of a yet another excise tax on the employment of labor services.

The Committee has heard at length, I am sure, of the nature and likely magnitude of the costs that employers are going to incur to determine whether their present fringe benefit plans conform with Section 89's requirements. Rather than reciting the nature of these tests and the kinds of costs they are likely to impose, I'll focus on the nature of the costs that employers will incur in attempting to comply with Section 89 and their broader implications for the economy as a whole.

Section 89 will increase the cost of labor services very widely throughout the economy. The administrative costs that a great many employers will incur in performing the specified tests to determine that their plans are qualified and nondiscriminatory are payroll costs, stemming uniquely from the use of labor services. The larger and more diverse the work force and, therefore, the existing compensation arrangements, the greater are these administrative costs likely to be.

In many cases, Section 89 will impel changes in compensation arrangements for one or another group of employees. One adjustment that is likely to be made in many cases is to drop the provisions in the health and life insurance plans deemed to discriminate in favor of so-called "highly-compensated" employees. The affected employees, of course, are not likely to accept the resulting reduction in compensation this would entail; the employer will have to provide other compensation the net-of-tax value of which is the same to the highly-compensated

employees as the insurance coverage they lose. Alternatively, the employer and the highly-paid employees may agree to continue the discriminatory compensation, including the "excess benefits" in the employees' taxable income. In this case, too, additional compensation to these employees will be required if they are not to sustain a cut in their net-of-tax compensation.

In some cases it is to be expected that employers will find both the administrative and the compliance costs of Section 89 too heavy and will drop the offending plans. In this case, too, other compensation elements will have to be provided if the affected employees are to be as well off as before.

A far less likely adjustment of health or life insurance plans found to be discriminatory would be to enrich the plans for the nonhighly compensated employees. This adjustment, clearly, is likely to have the greatest impact in raising the employer's payroll costs. Notwithstanding, there may be circumstances in which Section 89 would force this result.

Whatever the adjustment, the effect must be to raise total costs incurred by the employer in providing a satisfactory compensation package for employees. Almost invariably, the revised pay package for employees whose pay packages must be changed to comply with Section 89 will have a greater total dollar cost to the employer, simply to keep the employees as well off as they were before the adjustment. Obviously, if the total

dollar value of the new pay package were the same as the old, the new mix of compensation elements would be less desirable to the employee than the old one. If this were not the case, the employee would have sought the adjustment even in the absence of Section 89. If the total dollar cost of the new pay package to the employer is unchanged, it must be less valuable to the employee than the old one. To keep the employee as well compensated as before, therefore, the employer will have to increase the aggregate amount of the employee's compensation. Section 89 necessarily confronts every employer whose plans do not now conform with its requirements with an increase in the dollar cost of the work force.

Because nothing about the change in the components of the compensation package automatically increases employees' productivity, Section 89 must lead to both higher unit costs of labor services and lower levels of employment than otherwise would be the case. Section 89, just like an excise, imposes a wedge between the cost to the employer of using a given amount of labor services and the rewards obtained by those supplying those services. Like any excise, it reduces not only the quantity of the thing on which it is imposed but the efficiency with which it is used, as well.

Like any excise, it will disproportionately affect various groups of both employers and employees. For small businesses, the administrative costs, along with the increase in compensation

costs, may well be an intolerable burden. Larger businesses may have greater capacity for dealing with Section 89 complexities, but for many of these businesses complexity increases exponentially with their size and the diversity of their organizational arrangements. Indeed, for some large businesses the data base required to undertake the Section 89 tests are likely to impose costs all out of proportion to any discrimination in compensation that may be found. Cost increases are likely to be larger for relatively labor-intensive businesses than for those that are more capital-intensive. For this reason, Section 89 is likely to impose significantly differing burdens among industries, with significantly differing effects on production costs.

Conclusions

Along with a number of other recent legislative efforts and enactments ostensibly intended to benefit one or another group in the labor force, Section 89 will prove burdensome to employees across virtually the entire work-force spectrum. Because of its adverse effects on unit labor costs, moreover, it will impair American business' competitive position in the world marketplace. It will, in sum, make virtually all employees worse off than they otherwise would be. Its burdens will be particularly severe on those employees in the weakest economic position. And all of these adverse effects stem from a misguided pursuit of a careless misidentification of "fairness."

It seems likely that tax revenue gain rather than fairness was the true objective sought by Section 89. Unless the government's revenue estimators took full account of the dynamic adjustments that will be made to Section 89 throughout the economy, actual revenue gains are likely to fall far shy of those anticipated by the Congressional tax policy makers. These adjustments will entail increases in aggregate compensation costs, virtually all of which will show up as increases in tax deductions on employers' income tax returns. What revenue is gained will have been obtained at an inordinately high price to be paid by employers and employees alike.

Section 89 is misguided tax policy and bad economic policy. Its repeal would contribute to fairer and more efficient compensation arrangements throughout the economy.