

Employee Benefits and the New Economy: A Proposal for Reform

Daniel J.B. Mitchell

The current tilt in the U.S. tax code that favors the provision of "social insurance" to employees (i.e., benefits such as health insurance, life insurance, and pensions) should be ended. It may be worthwhile national policy to encourage persons to be covered by social insurance but there is no reason that employers should be the exclusive recipients of a subsidy for providing it. A tax-based subsidy to company-by-company social insurance interferes with labor mobility and gives an artificial advantage to employers to be social insurance suppliers over other potential providers. If national policy is nonetheless moving toward mandating universal social insurance coverage by employers, then the mandate should ensure that individuals can move from job to job without penalty.

It may seem peculiar to voice such sentiments, given the realities of the modern U.S. social insurance system. Roughly three-fourths of all non-elderly persons who have health insurance obtain it through their own employment or that of a family member. Ninety percent of full-time employees in medium-to-large firms have employment-related medical insurance. Two-thirds of the workforce aged 25 or over is covered by some sort of employment-related pension. The pension coverage ratio among full-time workers in medium-to-large firms has risen to 8 out of 10 employees, 70% of whom have a defined-benefit plan.¹ Thus, it may seem that employer-provided benefits are the natural order of things.

In fact, the development of the complex system of firm-level social insurance in the U.S. is the result of various historical accidents that were heavily reinforced by a tax subsidy. There is today a bureaucracy of benefit administrators in the nation's personnel departments. These functionaries have an obvious vested interest in promoting the idea that employers are

Exhibit 1. Pensions and Life Insurance: Empirical Background

Panel A: Percent of Civilian Wage and Salary Employees with Pension Coverage (1985), All Ages:

47%

Panel B: Pension Status of Wage and Salary Employees Aged 25 or Older by Size of Employer (1984):

	Covered by a Pension Plan	Vested in a Pension Plan
All Sizes	67.1%	45.1%
Under 25 Employees	24.7	15.1
25-99 Employees	49.7	33.5
100-499 Employees	70.5	46.9
500-999 Employees	81.8	55.8
1000 or More Employees	89.5	60.9

67.1% 45.1%
 24.7 15.1
 49.7 33.5
 70.5 46.9
 81.8 55.8
 89.5 60.9

Panel C: Type of Coverage of Full-Time Employees in Medium-to-Large Companies (1988):

	Percent of Employees with Coverage
Defined-Benefit Plan	63%
Defined-Contribution Plan	45
Life Insurance	92

63%
 45%
 92%

Panel D: Federal Tax Revenue Loss (FY 1990):

Due to Pension Tax Subsidy: \$45.1 billion
 Due to Life Insurance Tax Subsidy: \$2.7 billion

\$45.1 billion
 \$2.7 billion

Sources of Data: Panel A from U.S. Bureau of the Census, *Receipt of Selected Noncash Benefits, 1985*, Series P-60, No. 155 (Washington, D.C.: GPO, 1987), Table 14, and U.S. Bureau of Labor Statistics, *Labor Force Statistics Derived from the Current Population Survey, 1948-87*, bulletin 2307 (Washington, D.C.: GPO, 1988), p. 185. Panel B from U.S. Bureau of the Census, *Pensions: Worker Coverage and Retirement Income, 1984*, Series P-70, No. 12 (Washington, D.C.: GPO, 1987), p. 6. Panel C from U.S. Bureau of Labor Statistics, *Employee Benefits in Medium and Large Firms, 1988*, bulletin 2336 (Washington, D.C.: GPO, 1989), p. 3. Panel D from U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1991* (Washington, D.C.: GPO, 1990), p. A73.

Exhibit 2. Health Insurance: Empirical Background**Panel A: Percent of All Civilian Wage and Salary Employees with Employment-Related Health Insurance**

66%

Panel B: Type of Coverage of Full-Time Employees in Medium-to-Large Companies (1988)

	Percent of Employees with Coverage
Medical	90%
Dental	60
Sickness & Accident	46

90%
60%
46%

Panel C: Federal Tax Revenue Loss (FY 1990)

Due to Medical Insurance Care Tax Subsidy: \$28.8 billion

Due to Accident & Disability Insurance Tax Subsidy: \$0.1 billion

\$28.8 billion
\$0.1 billion

Sources of Data: Panel A from U.S. Bureau of the Census, *Receipt of Selected Noncash Benefits: 1985*, Series P-60, No. 155 (Washington, D.C.: GPO, 1987), Table 17, and U.S. Bureau of Labor Statistics, *Labor Force Statistics Derived from the Current Population Survey, 1948-87*, bulletin 2307 (Washington, D.C.: GPO, 1988), p. 185. Panel B from U.S. Bureau of the Census, *Pensions: Worker Coverage and Retirement Income, 1984*, Series P-70, No. 12 (Washington, D.C.: GPO, 1987), p. 6. Panel C from U.S. Bureau of Labor Statistics, *Employee Benefits in Medium and Large Firms, 1988*, bulletin 2336 (Washington, D.C.: GPO, 1989), p. 3. Panel C from U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1991* (Washington, D.C.: GPO, 1990), pp. A72-A73.

rewarded for providing social insurance by increased worker morale, loyalty, and productivity. Recently, such views have been endorsed by some economists who have assumed that because benefits are so common, they must serve a rational economic function within the firm. But again, those views represent a misreading of history and the tax code.

Because employer-provided social insurance is the norm in the U.S., Americans tend to neglect the possibility of obtaining such insurance from other sources. In fact, there are alternatives ranging from public provision through programs such as Social Security to private insurance obtained by individuals from commercial carriers or through groups such as fraternal organizations, unions, religious bodies, and others. The public model is common in European countries. And the private model was often used in the U.S. before World War II. Indeed, even today, those retired persons

who do not have employer-provided health care often purchase Medicare supplements privately.

Before going further, three qualifications need to be made. First, the author is not proposing to discourage employers from providing social insurance if they wish to do so (or if unions wish to continue to negotiate for it). Second, the author is not arguing that it is bad public policy to subsidize the provision of private social insurance.² The objectionable elements are that employer-provided social insurance receives tax subsidies not available to alternative providers, and that it hinders job mobility. Third, there are some benefits that are inherently job-linked and that are thus logically employer-provided. These include holidays, vacations, and other forms of leave. But such benefits are provided voluntarily without a tax subsidy. Hence, no public policy issues are involved and thus such inherently job-linked benefits are excluded from the following discussion.

Diversion of Managerial Resources

Administering employee benefits is not a costless activity for employers. Consider four hypothetical events:

- A regional telephone company finds its workers on strike over a company proposal to hold down health care costs through co-payments and similar cost-sharing arrangements.
- A manufacturer finds itself required to record future liabilities for retiree health care on its balance sheet. Its potential creditors become nervous when they see the estimates, raising the cost of capital to the firm just when it needs to make new investments.
- A financial services firm revamps its employee benefit package to meet the provisions of newly enacted Section 89 of the Internal Revenue Code. Substantial revisions are required and many employee lose benefits because of Section 89's strictures against discriminating in favor of highly paid employees. Having revamped its benefits and angered some key employees in the process, the firm discovers that Congress has decided to repeal Section 89.
- A retailer's pension plan appears to be overfunded due to high returns on the plan's portfolio. The retailer fears it will be the subject of a hostile takeover, since the seemingly flush pension fund makes an attractive target. To reduce the takeover risk, management terminates the pension plan and places the "excess" funds into an ESOP. Employees are given substitute annuities to compensate for the pension loss, but many feel the new retirement package is inferior to the old. Morale deteriorates, especially among long-service employees.

In each of these four cases, the firms involved could have used the resources diverted into benefit administration more productively.³ Surely, the

management of the phone company might otherwise have preferred dealing with the challenge of deregulation and the growth of competing communications systems. Perhaps the manufacturer might have preferred to focus its management attention on pressures from international competition. The financial services firm might have been better served had it devoted its energies toward efforts to win back customers scared away by stock-market volatility. And the retailer might have developed strategies for dealing with issues relating to changing demographics and their effects on its sales outlets.

In all of these cases, the basic problem is the same. Managing a tax-favored social insurance system is not what these firms do best. What they need to do best is to produce goods and services for the markets they serve. Benefit programs pull resources away from that central function.

The Accident of Social Insurance

The diversion of employer attention toward running social insurance systems is a comparatively recent phenomenon.⁴ In the early part of this century, employee benefit plans were virtually unknown. A few firms had pensions but these programs were often unvested and unfunded. Sometimes, if a long-service employee became ill, an employer might carry the employee for a time on the payroll. But real health insurance was not provided. In any case, employees tended to change jobs frequently. They were generally left to their own devices when it came to issues of old age or illness.

These devices ranged from relying on extended family members, saving privately, turning to private insurance carriers (mainly for small life insurance policies), or reliance on various fraternal, religious, or beneficial societies. Skilled workers in craft unions might also have received assistance from those organizations. For most employers, the obligation to workers stopped at paying a day's wage for a day's work.

A number of forces developed, however, that led to more widespread benefit programs. Turn-of-the-century social reform and uplift movements encouraged some employers to engage in "welfare work" among their employees. A sharp labor shortage during World War I spread the welfare idea, since it was depicted as a way of retaining scarce labor and as a device for union avoidance. Private insurance carriers saw the workforces at large, paternal firms as potential markets and made deals with major companies to offer life insurance. Problems of adverse selection could be reduced if companies provided life insurance to all employees. The carriers sought to indoctrinate the employer community with the notion that providing welfare programs would ultimately benefit the firm.

But during the 1920s, the labor shortage evaporated and the union threat receded. Many firms abandoned or cut back on their welfare work. Insurance carriers, fearful of losing newly obtained markets, sometimes managed to persuade firms to continue offering life insurance as an *employee-paid*

option. (This optional approach, of course, reintroduced adverse selection). The early years of the Great Depression dealt a further blow to welfare work; cutting out the "fringes" was seen as a good way for employers to reduce labor costs.

Three developments in the 1940s reversed these tendencies dramatically. First, wartime wage controls held down take-home pay but—in an effort to avert labor disputes—permitted deferred benefits to be negotiated. Second, the tax code was modified to prevent such schemes from being currently taxable to employees while permitting employers to deduct their costs immediately. The official rationale was that deferred benefits were a form of saving and were thus non-inflationary. Third, rapidly growing unions—particularly those of the old CIO—encountered a resurgent conservative political climate which blocked efforts at extending public social insurance. When it became clear that programs such as national health insurance were not in the offing, the unions made due with demands for private, employer-provided substitutes as interim measures until their national agenda could be achieved. Unions were aided in this objective by various court and administrative decisions that encouraged private bargaining over benefits.

By the 1950s, the modern outline of employer-provided social insurance could clearly be seen in the U.S., locked into place by the tax code. Groups with a vested interest in maintaining the new system arose to lobby in Congress for maintenance and enhancement of the tax subsidy. These included insurance carriers, benefit consultants, benefit administrators, and the companies and unions that had made a considerable investment in establishing benefit programs. In addition, Congress discovered that manipulating the tax code gave it control of a newly emerged private social insurance program that did not have to be run through the federal budget.

A careful review of the history of employer-provided benefits provides little evidence of micro-level efficiency as their source. Although there is much assertion of the value of benefits to employers by those with a vested interest in maintaining them, documentation by employers of such gains is rare in practice and has always been so. Private social insurance is the product of a sequence of historical accidents—wars, social movements, and the like. Absent the tax subsidy, much of the benefit edifice would crumble.

The Changing Economy

Two problems have arisen in recent years that make it appropriate to question the contemporary system of employee benefits. The first involves the stability of the employment relationship. The second involves the consequences of firm-by-firm benefit administration. The two issues are interrelated.

Job Security—The contemporary employment relationship is under strain.⁵ At one time, a good job was to be found at a large, paternal firm offering job security and a career ladder. At such a firm, the consequences of employee

mobility for the benefit package was not a major issue, since employment would last a long time (perhaps a lifetime). This phase in the American employment relationship appears in retrospect to have reached its height in the 1950s, the era of the careerist organization man at the higher white-collar level and the protected, unionized blue-collar worker in the factory. The 1950s were also a period of Galbraithian big firms and big unions, moderated by big government protective policies, which insulated them from international competition and other economic turbulence. Gradually, the elements of the 1950s economy eroded, leaving behind the tax-supported system of employee benefits as an anachronism.

In the 1980s, in particular, employment at big firms shrank while jobs at small employers grew. Unions suffered dramatic losses of membership. With flexible exchange rates and the international spread of technology, American employers became subject to volatile swings in competitiveness. Government deregulation opened up competition in utilities, communications, transportation, and finance. Fluctuations in food and energy inflation during the early part of the decade made macroeconomic policy erratic and hindered attempts at long-term corporate planning.

The less secure economic environment has been reflected in the labor market. Median tenure on the job has fallen since the 1950s. Substantial employee displacement has occurred and employers have become less willing to make job-security guarantees. Employers increasingly have turned to a contingent workforce of temporaries, part-timers, and independent contractors who are often outside the perimeter of private social insurance.⁶ While the 1950s benefit model focused on a male breadwinner with dependents, the workforce has become increasingly female and is no longer centered on a traditional family. These demographic trends have weakened the stability of the employment relationship; 1950s-era prime-aged males with traditional families to support were more strongly attached to their jobs than are contemporary employees.

Financial markets have also posed a challenge to a stable employment relationship. In the once-stable economic environment, viewing a big firm as an ongoing organization seemed natural. Successful firms were seen as those that nurtured their long-term employment relationships. However, this organizational view was increasingly challenged in the 1980s by the wave of corporate mergers, acquisitions, spinoffs, buyouts, and restructurings. This led to a new financial view in which the firm was seen as a collection of assets—a portfolio—that can be readily rearranged. Employer identity—and therefore employee relations policy—becomes a variable in such a world. In cases such as Continental Airlines and Greyhound Bus Lines, dramatic strikes have occurred when once-paternal employers were taken over by new owners.

These shifts in the economy and in the employment relationship have been much lamented and debated. But even those who argue for restoring stability might find it difficult to turn back the tide. Many of the tendencies

seen in the U.S. have also been found in other countries, suggesting the forces behind them are fundamental and not the result of uniquely American circumstances. Thus, it is important to bring the national private social insurance system in line with international realities.

Benefits, Flexibility, and Mobility—With worldwide pressures for flexible employment relationships developing, how does the American benefit system stack up? Employers abroad often view American firms as having more discretion and flexibility because of fewer legal constraints in the U.S. on an employer's ability to lay off workers. However, there is now a growing tendency in the U.S. to use legal channels to restrict the ability to lay off workers. The rising volume of wrongful discharge litigation and the 1988 legislative enactment requiring advance notice of mass layoffs are symptomatic of this trend. With regard to social insurance, however, foreign models are often more flexible than the American model.

Compared with the U.S., countries with elaborate national social insurance programs are in a better position to adapt to the economic environment despite the "socialistic" origins of some of these programs. Social insurance that is provided at the national level is 100% vested and portable. Workers in these countries can move from job to job without a benefit penalty. Consider, in contrast, the plights of Sally and George, two workers in free-enterprise America.

- Sally has worked for her firm for several years and is covered by its health insurance plan. As a single parent, Sally has also signed up her children. One of these children was injured in an automobile accident and will require an extended series of expensive treatments. Fortunately, Sally's employer-based health plan pays most of the costs. But Sally has discovered that if she changes jobs, she might lose this valuable coverage. Even if a new employer had a health plan, it might not cover pre-existing conditions such as her child's injury. Sally is not happy with her job and would like to find an alternative. But she cannot change jobs without risking large out-of-pocket medical expenses. So she decides to stay put.
- George, age 45, has been on his job for 15 years and has long since vested in his company's defined-benefit pension plan. Recently, the firm has been downsizing and George feels it might be prudent to find a job at another firm with a brighter outlook. But George knows that he won't reach early retirement age under his current pension plan for another 10 years. And he discovers an anomaly. Suppose he were to quit now and take a job for the same 10 years at another firm with an identical pension plan. The two pension benefits he would then receive would add up to less than he would obtain by remaining in his current job. In the strange world of pension formulas $15 + 10$ is less than 25. Moreover, if George quit now and took another job, there would be no guarantee the new one

would last 10 years. If it lasted less than 5 years, he wouldn't vest at all under the new plan and would receive no benefits from it. Rather than search for a new job, George decides to stay with his current employer and hope for the best.

The two examples just cited are relatively benign. They indicate the limits on mobility inherent in contemporary private social insurance in the U.S. But so far Sally and George are in a position to decide voluntarily whether to remain on their current jobs. The system is less benign when jobs are discontinued involuntarily and individuals are forced to seek new employment. In such cases, the heavy mobility penalties cannot be avoided.

A Special Pension Issue: Plan Terminations

One of the most controversial benefit issues that arose in the 1980s was the consequence of pension plan terminations. Under American pension law, a pension plan is considered "overfunded" if it has more assets on hand than it needs to cover current liabilities. But these liabilities are calculated as the expenditures that would be necessary if the entire workforce covered by the plan quit immediately. Generally, the assets needed to cover such a hypothetical mass exodus would be insufficient to cover the ongoing expenses of maintaining the plan, given normal retirement and turnover patterns. As George discovered, quitters tend to be cheaper than stayers. Indeed, those quitting before becoming vested carry no current liability at all. Thus, plans reported to be overfunded may not in fact have sufficient assets to cover ongoing costs.

Pension terminations are legal, although they effectively void the implicit contracts of long-service employees. The difficulty from the employee viewpoint is that implicit contracts are generally unenforceable; they are built on trust. An employee under a retirement plan must rely on the employer's good faith to continue it. And in a volatile economic environment, trust and good faith are early casualties.

The traditional American solution to such problems is to establish an overlay of new government regulations. In fact, there has developed a complex set of federal rules governing pension coverage, vesting, insurance of benefits, withdrawal of employers from multi-firm plans, and the investment of pension assets. But these costly regulations provide added incentives for employers to terminate their existing plans and discourage the creation of new ones, especially by smaller employers.

One study, based on Internal Revenue Service data, indicates that the proportion of pension-covered workers with defined-benefit plans as their primary program fell from 89.7% in 1977 to 79.3% in 1985.⁷ About half the drop was due to changing patterns of employment and the rest due to changes in employer pension policies. The regulatory approach to ensuring

employer good faith is thus inadvertently exacerbating the decline of defined-benefit pensions. American public policy—which insists that the primary unit of social insurance should be the individual employer—is the root cause of this dilemma. Even employees who are not seeking to change jobs, and who are not being laid off, are at risk of suffering the effects of a pension termination.

A Special Health Insurance Issue: Cost Containment

For a long time, prices of health services have risen faster than the prices of other goods and services; and the quantity of health services consumed has risen faster than other components of national expenditure. The U.S. is devoting more and more resources to the health sector and paying more and more for them.

One element in the upward push in health care costs is inherent in any system of social insurance. The essence of health insurance is that the patient's marginal cost of consuming health care services is reduced substantially below the actual resource cost. In a standard fee-for-service plan, once the covered individual has met the deductible, most of the incremental service cost (often 80%) is picked up by insurance. Often there is a stop-loss feature that provides 100% reimbursement beyond a specified dollar limit, making the patient's marginal cost zero. Lower-than-actual marginal costs provide incentive to increase consumption of health services. In addition, unlike most consumer products, the amount of health services consumed is significantly influenced by suppliers (doctors and hospitals) who have expertise in medical technology and have a financial stake in additional consumption. Suppliers know that the expenditure decisions they make on behalf of patients will be largely covered by third-party payers. Thus, the potential for excessive usage is compounded.

These two factors—low marginal costs and supplier decision-making—should in theory reach an eventual limit, i.e., a larger fraction of the national product would be consumed in the health care sector, but not an inexorably rising share. So far, however, such an equilibrium has not been reached, despite various health care cost containment efforts. With the baby boomers now approaching ages at which medical costs begin to rise, achievement of an equilibrium will become even more difficult in the future.

Public policy inherently assumes that individual employers are likely to be good cost containments. And indeed, many employers have involved themselves in local groups seeking to control health expenses. They have learned about HMOs, PPOs, and DRGs. They have experimented with second opinions and "managed care." Yet there are built-in difficulties in assuming that employers have adequate incentives or means to control health costs on a company-by-company basis. Employers themselves are becoming skeptical of their ability to deal with health inflation.⁸

First, there is the classic "free-rider" problem. If one firm generates local initiatives that reduce health costs, all employers—including those not actively engaged in control efforts—will benefit. Larger firms are better positioned than smaller ones to capture the gains of local cost control. Thus, if a new cohort of small firms are required to offer health insurance under a government mandate—as has been proposed—the new conscripts will not be active in the cost containment movement.

Second, there is both evidence and economic theory supporting the proposition that in the long run it is employees who pay for social insurance including health care.⁹ Ultimately, take-home pay is lower to the extent that the costs of such programs is higher. This tendency suggests that savings achieved by employers are ultimately passed to employees, not to profits. So again, employers may not capture the full gains of cost savings and thus have incomplete incentives to achieve them.

Third, there is no reason to suppose that employers naturally possess special expertise and capability in running a social insurance system and containing its costs. Indeed, firms are ultimately successful because of their product-market abilities, which need not bear any relationship to the ability to manage a health plan. Administering such a plan is a diversion of managerial effort from the firm's chief function.

The idea that the logical locus of the solution to the nation's rising bill for health care is at the employer level is false. It is simply an outgrowth of the historical accidents that established employers as health care insurance providers. Perhaps the best way to break out of this mindset is to imagine what would have happened if, in the 1940s and 1950s, Congress had decided that automobile liability insurance also belonged in the workplace. Suppose Congress had provided a tax subsidy to employer-provided auto insurance comparable to what it actually provided to health insurance. Today, human resource executives would be spending their time worrying about traffic safety, bumpers and airbags, no-fault insurance, and collision repair costs. Auto insurance cost containment would be a key topic among compensation administrators. The idea that such executives would have expertise in these areas seems absurd only because Congress did not provide the tax subsidy for auto insurance that it did for employer-provided health insurance.

Status Quo or Change?

Two arguments might be made for leaving in place the current public policy of subsidizing company-by-company social insurance. First, it might be argued that providing social insurance somehow raises company productivity to such an extent that a tax subsidy is warranted. Second, there is simply the pragmatic view that the system is so widespread and ensconced that changing it would be too disruptive. Both these considerations are discussed below.

Efficiency Arguments—Both pensions and health insurance have been said to provide benefits to employers offering them. It is not surprising that benefit administrators make such claims since they have a vested interest in the current approach. However, in recent years some economists have also produced theories in support of the proposition that benefits promote efficiency, particularly with regard to pensions.

The economic argument is part of the larger "efficiency wage" model developed in the 1980s. According to this model, as applied to pensions, the deferred nature of eventual pension benefits and the backloaded formulas under defined-benefit plans are part of a motivational strategy. If the employee does not perform at an adequate standard today, he/she will be terminated and will lose an important entitlement to deferred compensation tomorrow. To the extent that health insurance and other benefits are not completely portable, similar arguments could be made for them as well (although the literature has not done so).¹⁰ In effect, the benefit package acts as an ersatz performance bond.

Interesting though the efficiency wage argument may be, it does not justify a tax subsidy to pensions or other benefits. First, if employers want to create performance bonds, they can do so without tax-favored benefit plans. Indeed, in one of its original formulations, the efficiency wage model was articulated as a seniority-linked wage in a career employment model. Employees would initially be paid a comparatively low wage which would rise with their years of employment with the firm. The promise of high pay in the future would act as the performance bond. Such employment contracts were said to characterize large Japanese firms. It was only as empirical evidence for the existence of seniority-linked wages in the U.S. proved ambiguous that the model became increasingly applied to pensions.

Second, even if it were clear that pensions function as performance guarantees, the case for a public subsidy for such plans would not be made. If employers capture the gains of deferred compensation system in the form of higher productivity, they have adequate incentive to install the plans without government subvention. A case for subsidy would have to depend on an employer's inability to capture gains from higher productivity.

Third, in actual practice pensions may hinder productivity improvement. Pensions create generalized retention incentives but sometimes employers do not want to retain all employees. Downsizing may be necessary in the face of competitive pressures or technological advance. But since defined-benefit pensions inflict special costs on employees who are laid off, some employers have felt compelled to design costly early retirement options to offset the pension effect. That is, in a volatile economy it is often necessary to undue the retention incentives created by a pension plan.

Fourth, the formulas used by real-world pensions do not seem to be the product of careful determination of incentive effects. The incentive effects are across the board, holding in place poor performers as well as the most

productive employees. For example, pension eligibility is not linked directly to performance appraisal, the way merit pay often is. Moreover, pension formulas have arbitrary markers such as 5 years for vesting, 55 for early retirement, and 65 for "regular" retirement. Is it really rational to create golden handcuffs for those approaching these markers (say, someone aged 53 or 54) but not for someone who has reached the marker? Is it rational to make the magnitude of the retention incentive depend on the difficult-to-forecast general rate of inflation? That is what contemporary defined-benefit pension formulas typically do.

The case for health insurance (or life insurance) as an efficient human resource retention policy is even shakier. Does the firm really have a special interest in retaining sick employees, or those with medical problems among their dependents (such as Sally)? As Sally's example illustrated, such effects are built into a decentralized system of workplace-linked health insurance without portability guarantees.

The Pragmatic Case for the Status Quo—Seen as a social policy, rather than an employment policy, there is one key issue that has been before Congress whenever social insurance questions have arisen: covering the American population with adequate protection from the vagaries of life at reasonable cost. The location of social insurance should have been a secondary question. Thus, the social policy rationale does not explain why social insurance *at the workplace* should be the chief beneficiary of Congressional largesse.

Given the history of federal policy, however, it could be argued that the status quo should be maintained simply because it is the status quo. So many people are covered by workplace social insurance that any shift in policy could be harmful. The problem with this approach is that the shifts in the economy already described are already disrupting the 1950s-model of social insurance. Pension terminations, the shift away from defined benefits, the inability of private cost containment to cope with a national problem of health care inflation, and the desire in Congress to widen the net of social insurance are all pushing toward a reexamination of social insurance fundamentals. The status quo cannot really be maintained. New approaches are needed, albeit with due care to avoid disrupting the flow of benefits upon which millions of Americans have come to rely.

What Should be Done?

Disruption can be minimized if social insurance is made truly portable. Employees should be able to move from job to job—whether voluntarily or due to layoff—without loss of entitlements. For pensions this means rapid vesting, formulas that do not discriminate against mid-career quits and separations, and/or greater reliance on defined-contribution rather than defined-benefit plans. For health insurance this means the ability to change

jobs without loss of coverage of pre-existing medical conditions of primary employees or their dependents. Premiums charged to employers for health insurance coverage must be based on the average employee in the covered workforce so that there is no incentive to discriminate against new hires with pre-existing ailments.

Portable Health Insurance—Readers will have noted that the goals just enumerated sound remarkably like Social Security. Employers pay a fixed tax to the Social Security system for the various coverages it provides, chiefly a defined-benefit pension, disability insurance, and Medicare for the elderly. The tax is based on average costs, not the health or age of any individual worker. Hence, employers have no incentive to discriminate against any individual or class of employees. Employees can shift from job to job without loss of benefits. The employer is relieved of administrative costs other than tax payment.

A number of European welfare states have elaborate social security programs including health insurance for the non-elderly and other benefits that go beyond the American model. There is less reliance on private social insurance in these countries. As already noted, these systems are more compatible with a free labor market than the private American system of company-by-company benefits which hinders labor mobility. Particularly with regard to health insurance, the European model is beginning to look more attractive than the American. Indeed, a number of U.S. employers, fed up with their ability to contain costs have begun to advocate the European approach for the United States. Public opinion also seems to be receptive.¹¹

A proposal for an American system of national health insurance—whatever its virtues or demerits—is sure to run into substantial opposition because of its potential displacement of private providers. But such a system could be administered using private institutions. Private insurance carriers could be used to provide elements of the system ranging from providing the insurance to processing claims. For example, private carriers could bid for the right to provide coverage to blocs of, say, 100,000 individuals. Private employers could continue to provide coverage beyond what the central system offered, but with provisions for some type of continuation of benefit rights upon separation. And whatever tax subsidy is offered to such supplemental plans should be available to providers other than employers, and to individuals themselves.

If a centralized fund is deemed undesirable, benefits could be provided according to a mandated minimum schedule at the employer level, along the lines of the various proposals that began to be floated in Congress in the late 1980s. Again, portability is the key. Individuals should be enabled to move from job to job without loss. Thus, a centralized mechanism of transfer payments between insurance providers would need to be devised. Such transfers would be designed so that employers who happened to accumu-

late a disproportionate number of high-risk workers would not pay more per employee than the national average. In short, private social insurance can and should be made to function along the lines of a national plan.

While these alternative proposals all envision universal coverage, there could be moves in the direction of freer mobility even if universality is not part of the program. At the very least, the tax benefits now available to employer-provided plans should be available to individuals including the self-employed and those working for employers who do not provide health insurance. There should be a level playing field created for the purchase of health insurance without regard to source.

None of these proposals, by themselves, will solve the cost-containment problem. That problem is national in scope, however, and cannot be resolved at the workplace. Solving the problem of rising health costs will require a national consensus on such delicate issues as rationing of access, which so far does not exist. But the proposals made above do address the issue of labor mobility.

Pension Portability—For defined-contribution pensions, there is no real issue of portability so long as there is quick vesting. Under such plans employees essentially have tax-deferred savings accounts through their employer. If they leave their jobs, voluntarily or involuntarily, they can take their accounts with them by rolling the funds into an IRA. Or they can leave them with their old employer. Employment-based savings arrangements such as 401k plans and 403b plans fall into the same category. To make the playing field truly level, however, the limits on contributions to IRAs should not be different from those applicable to employer-based plans. Employees should be free to choose whether to save through their employers or through their own IRAs.

It is defined-benefit pension plans that cause the major portability headaches. The key issues are the lumpiness of their benefit schedules and their interaction with inflation. As George's example illustrates, such plans typically have discrete points of age and seniority at which the present value of the benefits jump. Moreover, since plan benefits are often linked to end-of-service earnings, they provide differential inflation protection depending on the gap between an employee's end of service and his/her end of working life. In an inflation-prone economy, someone who leaves an employer before actual retirement will ultimately receive a benefit based on an obsolete level of wages and prices. Someone who stays with an employer for a lifetime will have benefits that are initially based on the current wage and price level. Even 100% vesting does not do away with this mobility-hindering discrepancy.

From purely a mobility viewpoint, the "simple" solution is to promote defined-contribution plans—and 401ks and 403bs—over defined-benefit plans (and to end discrimination against IRAs). But such a policy shift would harm those now under defined-benefit systems, especially persons

close to retirement. Moreover, the security provided by defined-benefit plans, at least to long-service employees who stay until retirement, is of potential value and cannot be provided under the current defined-contribution model. Employees who do stay the course with a single employer are assured of a retirement benefit that is linked to their pre-retirement living standard.

The solution must therefore involve some compromise. Difficulties surrounding the administration of defined-benefit plans—and the rising cost of federal termination insurance for them—are already pushing the private retirement system toward the defined-contribution model. It is worth noting, however, that for most workers federal Social Security will be a major source of retirement income. In a typical defined-benefit plan, a worker with final earnings of \$35,000 in 1988 and 30 years of service would initially have received half his/her retirement income from Social Security and half from the pension.¹² Since Social Security is a defined-benefit plan (with 100% inflation protection), an important component of a retirees' income will be based on a defined-benefit formula even if he/she draws other retirement income from a defined-contribution plan.

Defined-benefit plans could be encouraged to move toward formulas that reduce the disadvantage to the outwardly mobile participant. Basically, such adjustments would entail smoothing out the benefit formulas to avoid their current lumpiness plus some adjustment for inflation between quitting and retirement age for those who leave early. The tax code does not require that the plans have arbitrary markers in their formulas. But it does not discourage such formulas either. It should.

There are costs to such changes, of course. Under the current formulas used in defined-benefit plans, the disadvantage faced by early leavers helps finance the eventual benefits of long-term stayers. Thus, any shift in formula should be accomplished in gradual stages with protections for those nearing retirement. In particular, 1980s-style cheap terminations of defined-benefit pensions, and their replacement by undervalued annuities, should be discouraged. Employees whose defined-benefit plans are terminated should receive truly equivalent compensation for their loss.

Public Policy Implications—Moves to reduce the anti-mobility effects of private social insurance could have implications for the federal budget. Clearly, creation of a national health insurance scheme could have major budgetary consequences. And just providing equal tax treatment for all social insurance—whether employer provided or not—would reduce tax revenues, other things being equal. For example, if individually purchased health insurance received the same tax treatment as employer-provided insurance, or if IRAs were subject to the same provisions as employer-provided pensions, significant revenue losses would occur.

Tax subsidies, however, are subject to the same discretion as other forms of expenditure. This article argues that whatever amount is to be spent, the

tax code should not favor employer provision of social insurance over other forms. And it should not support benefit packages that hinder labor mobility. If firms wish to construct compensation systems that limit mobility, they are free to do so, but a public subsidy for such personnel policies should not be provided. How much Congress wants to spend on all social insurance is another matter entirely. It can change the amount by being more or less liberal with the tax treatment of such insurance.

Whatever Congress' decision on the total expenditure, the long-held presumptions that social insurance inherently belongs in the workplace, and that employers are uniquely equipped to solve such problems as health care inflation, need to be abandoned. Moreover, the views expressed here should cut across the political spectrum. For liberals, there is offered the opportunity to create universal and comprehensive social insurance. For conservatives, there is the attraction of creating a truly free and competitive labor market. For employers, there is a chance to shed the elaborate burdens of a privately run social insurance system. And for ordinary employees, there is the prospect of being able to meet basic health and welfare needs without the need to rely on continuing employer generosity.

References

1. Data cited are drawn from U.S. Bureau of Labor Statistics, *Employee Benefits in Medium-to-Large Firms, 1988*, bulletin 2336 (Washington, D.C.: GPO, 1989), p. 3; U.S. Bureau of the Census, *Pensions: Worker Coverage and Retirement Income, 1984*, Current Population Series P-70, no. 12 (Washington, D.C.: GPO, 1987), p. 2.
2. Apart from arguments that social insurance is simply "a good thing to encourage," there is a more conservative argument that individuals without it end up receiving *de facto* coverage from a variety of tax-supported programs.
3. Those who follow the compensation field will recognize that these hypothetical events accord with recent trends.
4. An earlier version of this article, available from the author, provides detailed footnotes to the references supporting this section.
5. More detail on the economic trends cited below can be found in Daniel J.B. Mitchell, "Wage Pressures and Labor Shortages: The 1960s and 1980s," *Brookings Papers on Economic Activity*, 2 (1989): 191-231; Sanford M. Jacoby and Daniel J.B. Mitchell, "Sticky Stories: Economic Explanations of Employment and Wage Rigidity," *American Economic Review*, 80 (May 1990): 33-37.
6. Richard S. Belous, *The Contingent Economy: The Growth of the Temporary, Part-Time and Subcontracted Workforce* (Washington, D.C.: National Planning Association, 1989).
7. Alan L. Gustman and Thomas L. Steinmeier, "The Stampede Toward Defined Contribution Pension Plans: Fact or Fiction," working paper no. 3086, National Bureau of Economic Research, 1989.
8. Bureau of National Affairs, Inc., "Effective Health Cost Containment Strategies Implemented by Few Employers, HR Survey Finds," *Daily Labor Report*, June 26, 1990, pp. A2-A3.
9. Perhaps the most obvious piece of evidence is the long-run tendency of real compensation (including benefits) and productivity to move in tandem. We expect real pay to move with productivity. If benefits form part of pay, they should substitute for wages

- leaving the relationship unaltered. The pay-productivity relationship was somewhat distorted in the late 1970s and early 1980s by certain upward biases in the Consumer Price Index. But if real consumption is measured using the same nonfarm business deflator used to obtain the productivity measure, then real compensation per hour rose at a 1.6% annual rate during 1960-89 versus a nearly identical 1.7% for productivity.
10. The issue here is not the validity of the efficiency wage concept in the abstract but its application to pensions and other benefits. References to the efficiency wage model can be found in George A. Akerlof and Janet Yellen, eds., *Efficiency Wage Models of the Labor Market* (New York, NY: Cambridge University Press, 1986); Joseph E. Stiglitz, "The Causes and Consequences of the Dependence of Quality on Price," *Journal of Economic Literature*, 25 (March 1987): 1-48.
 11. Lee Iacocca, *Talking Straight* (New York, NY: Bantam Books, 1988), p. 295; Robert Steinbrook, "The Times Poll: Majority Favors Reform of U.S. Health Care System," *Los Angeles Times*, February 4, 1990, pp. A1, A26.
 12. U.S. Bureau of Labor Statistics, *Employee Benefits, 1988*, op. cit., p. 91.