Some Simple Economics of Mandated Benefits

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When it has been decided that universal access to a good is to be provided, governments in some cases provide it directly, as with public education and old-age benefits almost everywhere and health benefits in many countries. In other cases, governments mandate that employers provide benefits to workers or that persons obtain benefits directly themselves. Requirements that employers keep workplaces safe and provide Workman's Compensation Insurance represent a clear example. Unemployment insurance provides an interesting middle ground. While in most European countries it is financed from general revenues, in the United States, employers are required to pay for the benefits their workers receive, because unemployment insurance taxes are experience rated, albeit imperfectly.

As a general proposition, liberals rank alternative strategies in the order of public provision, mandated benefits, then no action for addressing social concerns. Conservatives have exactly the opposite preferences, ranking the alternatives no action, mandated benefits, and then public provision. With these preference patterns, it is little wonder that governments frequently turn to mandated benefits as a tool of social policy. Mandated benefits raise a host of questions, however: What determines the choices governments make? Are there differences in the real effects of mandated benefits and tax-financed programs? Are there efficiency arguments for the use of mandated benefits?

These questions played a prominent role in the recent presidential campaign, with its debates over mandated health insurance, parental leave, and plant closing notification. More generally, there has been a great deal of recent interest in mandated benefits as a tool of social policy. As Frank McArdle notes: "[There is] an intense interest in mandated benefits issues.... Most of the current inspiration consists of extending to the non-covered population valuable, extensive, and socially desirable benefits policies that many companies provide on their own or through collective bargaining" (1987, pp. *xxxiv–xxxv*). Economists have generally devoted little attention to mandated benefits—regarding them as simply disguised tax and expenditure measures. Uwe Reinhardt's reaction is probably typical: "[Just because] the fiscal flows triggered by mandate would not flow directly through the public budgets does not detract from the measure's status of a *bona fide* tax" (1987, p. 124).

This paper tries to sort out some basic analytic points that need to be kept straight in considering the economics of mandated benefit proposals. Judgments about specific policy proposals must depend on the particulars, but I find that there are important differences in the efficiency and distributional consequences of standard public provision and mandated benefit programs. Essentially, mandated benefits are like public programs financed by benefit taxes. This makes them more efficient but less equitable than standard public programs. Section I lays out some efficiency arguments favoring government intervention in private employment contracts. Section II disputes the assertion that mandated benefits are really just disguised taxes, and contrasts the effects of government-mandated benefits with taxes and public provision. Section III discusses

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some problems with the use of mandated benefits.

I. Efficiency Arguments for Mandating Employee Benefits

Analysis of competitive equilibrium militates against mandating employer benefits, just as it militates against other government interventions. Imagine that employers can compensate their workers in different ways: with cash, by providing them with insurance, or by giving them consumption goods directly. If employers and employees can negotiate freely over the terms of the compensation package, they will reach a mutually efficient outcome. If a health benefit that would cost an employer \$20 to provide is worth \$30 to prospective employees, employers could provide the benefit and reduce the employee's salary by between \$20 and \$30, leaving both better off. Reasoning of this sort demonstrates that benefits will be provided up to the point where an extra \$1 spent by employers on benefits is valued by employees at \$1.

When is there ever a case for mandating benefits or publicly providing goods that employers could provide their workers? Most obviously, there is the paternalism, or "merit goods," argument that individuals value certain services too little. They may irrationally underestimate the probability of catastrophic health expenses, or of a child's illness that would require a sustained leave. In the pension context, this argument may be especially persuasive since individuals are likely to be especially inept at making intertemporal decisions. A closely related argument involves the idea that society cares more about equal consumption of some merit good commodities than about others.

There are at least two further rationales for mandating benefits that do not assume individual irrationality. First, there may be positive externalities associated with the good—externalities that cannot be captured by either the provider or the recipient. The most obvious example is health insurance. Society cares about preventing the spread of contagious diseases more than any individual does or would take account of. Further, people prefer for their friends and relatives to remain healthy, yet they cannot individually subsidize health insurance for all other consumers.

Much more important is the externality that arises from society's unwillingness or inability to deny care completely to those in desperate need, even if they cannot pay. The Congressional Budget Office estimates that there are 23 million American employees without health insurance. Health insurance for this group would cost about \$25 billion. Currently, these uninsured employees incur \$15 billion in health care costs for which they do not pay. The costs are borne in part by physicians and other providers of health care, but most of the cost is passed on to other consumers in the form of higher insurance and medical costs.

The externality here is quite large. About 60 percent of the benefit of employer-provided health insurance accrues ultimately to neither employer nor employee. Even with the current tax subsidy to employer-provided health insurance, there might be a further case for government action.

There is an interesting relationship between the paternalism arguments and the "protect others from paying" argument for mandating benefits. Folklore has it that universities mandated pension contributions for professors because they did not want to incur the costs of dealing with imprudent and impecunious retired professors and their spouses. By mandating contributions and forcing professors to save for themselves, universities avoided the problem. Where those who do without are institutionally able to foist themselves on someone other than their employer, there is a similar efficiency argument for government action.

Externality arguments can be used to justify other mandated benefits. Since unemployment insurance is only partially experience rated, layoffs at one firm raise taxes at others, creating an efficiency case for policies that would interfere with the private layoff decision. Mandatory plant closing notification is one such policy. There is an externality case for it also insofar as layoffs have adverse consequences for communities. The externality case for parental leave is more difficult to make, though even here there is the question of whether the benefits to the child of parental leave provide some justification for public policy intervention.

There is a second, perhaps stronger, argument for government intervention in the market for fringe benefits based on adverse selection considerations, as discussed for example in Michael Rothschild and Joseph Stiglitz (1976). If employees have more information about whether they will need parental leave or face high medical bills than their employers do, then employers that provide these benefits will receive disproportionately more applications from employees who require benefits and so will lose money. The market thus discourages provision of any fringe benefits.

Suppose, for example, that for the 10 percent of the population that knows it has health problems, health insurance is worth \$300 and costs \$270 to provide, and for the 90 percent of the population without preexisting conditions, health insurance is worth \$100 and costs \$90 to provide. Assume that individuals know whether they have problems or not, but employers cannot tell healthy from unhealthy individuals. Now consider what happens if employers do not offer health insurance. Any employer offering health insurance and a salary reduction of less than \$100 would attract both classes of workers and would lose money, since the average cost of insurance would be $\$.9 \cdot 90 + .1 \cdot 270 = \$108$. Firms could offer insurance and reduce wages by between \$270 and \$300. This would attract only unhealthy individuals. Even leaving aside the consideration that for productivity reasons, firms might not prefer a personnel policy that was most likely to attract unhealthy workers, it is clear that the market solution will not provide universal insurance even though all individuals are willing to pay more than it costs to insure themselves.[1]

The same argument holds in the case of other employee benefits. Workers know much better than their employers whether they are likely to go on parental leave or become disabled. They probably also know something about whether they are likely to become enmeshed in employment disputes. This suggests that there are efficiency arguments for limiting employers ability to fire workers at will.

These two considerations suggest that it may be optimal for the government to intervene in the provision of goods that some employers provide their workers.[2] In the next section, I take up the question of the form of government provision.

II. Mandated Benefits or Public Provision

It is often asserted that mandated benefits are just hidden taxes with the same efficiency and incidence implications as taxes, so that the choice between public provision and mandated benefits should depend only on the relative efficiency with which employers and the government can provide a service. I challenge the equivalence of these methods of provision below. But even granting the equivalence, there should be at least some presumption in favor of mandated benefits. Mandated benefits preserve employers' ability to tailor arrangements to their workers and to offer more than minimum packages. This avoids what might be called the "government provision trap" discussed in the context of higher education by Sam Peltzman (1973). Suppose that the government provides universal free health care of modest quality. This will be more attractive to many than paying the costs of high-quality care themselves, even though if they had

[1]The point is made more vivid by considering a strategy of attracting workers by offering a superior AIDS insurance policy.

[2]An alternative argument towards the same conclusion is that in a noncompetitive labor market such as one with either efficiency wages or monopsony power, there is no assurance that efficient compensation packages will be attained. In the Shapiro-Stiglitz (1984) model, for example, where firms will seek to structure employment arrangements to maximize workers' costs of job loss rather than to maximize their utility given their costs, there is no reason to expect the provision of efficient fringe benefits. I do not stress this argument because its predictions about the details of compensation are not very clear.

to pay for all their care they would have selected high- rather than low-quality care.[3]

Another argument in favor of mandated benefits rather than public provision is that mandated provision avoids the deadweight loss of tax-financed provision. Estimates of the marginal deadweight loss from a $1 increase in taxes range from the $1.07 suggested by Charles Stuart (1984) to the $1.21 suggested by Edgar Browning (1987) to the $1.33, as in Charles Ballard et al. (1985). These figures are probably underestimates since they recognize only a few of the many distortions caused by the tax system. This suggests that there are substantial efficiency gains to accomplishing social objectives in ways other than government taxation and provision. There is also the consideration that at the present time in the United States, the nature of budgetary bargaining makes it difficult to find funds even for programs that are very widely regarded as having substantial benefit-cost ratios.

Mandated benefits do not give rise to deadweight losses as large as those that arise from government tax collections. Suppose that the government required that all employers provide a certain benefit, say a leave policy, that cost employers $.10 per employee hour to provide. What would happen? Consider first employers whose employees previously valued the benefit at more than $.10 per hour and so had a leave package greater than $.10 per hour. They would not be affected at all by the government mandate, since they were previously in compliance with the law. For employees who valued the benefit at less than $.10 an hour, they would then receive the plan, at the cost of $.10.

[3]This difficulty could in principle be avoided by public programs that partially compensated those seeking high-quality private sector care. In practice, it is hard to imagine the government contributing substantially to medical costs for veterans who do not use the VA hospital system, providing the cost of a public school education to parents who send their children to private schools, or giving rebates to the poor who choose not to take advantage of low-income housing programs.

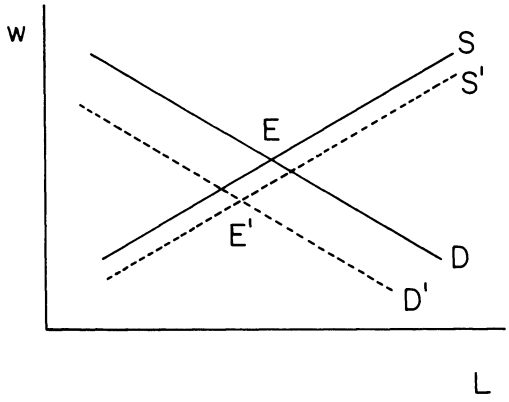

FIGURE 1. THE EFFECTS OF MANDATED BENEFITS

What would happen to the wages of those receiving the benefit? Figure 1 illustrates the answer. Requiring employers to pay for employee leaves shifts their demand curve downwards by $.10. Guaranteeing the benefit to employees shifts their supply curve downward by an amount equal to the value of the benefit. A new equilibrium level of employment and wages is reached, with lower wages and employment, but in general employment will be reduced by less than it would be with a $.10 tax.

Two special cases are instructive. First, suppose that the mandated benefit is worthless to employees. In this very special case, the change in employment and wages corresponds exactly to what would be expected from a $.10 tax on employers. Since the mandated benefit is worthless to employees, it is just like a tax from the point of view of both employers and employees. Second, consider the case where employees valuation of the policy is arbitrarily close to $.10. In this case, the mandated benefit does not affect the level of employment, the employer's total employee costs, or the employee's utility.

The general point should be clear from this example. In terms of their allocational effects on employment, mandated benefits represent a tax at a rate equal to the *difference* between the employers cost of providing the benefit and the employee's valuation of it, *not* at a rate equal to the cost to the employer of providing the benefit.

With this in mind, contrast the effects of mandating benefits with the effects of taxing all employers and using the proceeds to finance a public parental leave program. In the latter case, employers would abandon their plans, and the government would end up paying for all parental leave. This would mean far more tax distortions than in the mandated benefits case for two reasons. First, employers and employees who were unaffected by the mandated benefit program would be taxed for the parental leave program. This creates a larger deadweight loss. Second, for those employers and employees who are affected, the tax levied is equal to the full cost of parental leave, not the difference between the employers cost and the workers' benefit.

Where is the efficiency difference between the two approaches coming from? To see the answer, suppose that the public parental leave program was exactly tied to the number of hours an employee worked in the past and to his or her wage. In this case, with rational employees, the program would not be distortionary because the extra parental leave one would get by working more hours would offset the extra tax payments. Mandated benefits have effects paralleling benefit tax-financed public programs. Without close links between taxes and benefits, that tend to be lacking in public programs, large distortions can result.

Exactly the same analysis could be carried out with respect to health insurance, but one extra complication must be recognized. Workers do not get more health insurance if they work more hours. Hence, mandating employer health insurance should not affect employees' decisions about working a marginal hour. A public program could achieve the same effect if it was financed by a lump sum tax on employees rather than on payroll or income, but such taxes are not normally contemplated. In the case of health insurance, a lump sum tax is the appropriate benefit tax, since benefits do not rise with income. If labor force participation is very inelastic, but hours of work are quite elastic, then a mandated benefit program will involve less distortion than a tax-financed benefit program given the government's normal tax instruments.

This analysis suggests at least two possible advantages of mandated benefits over public provision of benefits. First, mandated benefits are likely to afford workers more choice. Second, they are likely to involve fewer distortions of economic activity. Why then should not all social objectives be sought through mandated benefits? I take this question up in the next section.

III. Some Potential Problems with Mandated Benefits

The most obvious problem with mandated benefits is that they only help those with jobs. Beyond the 25 million employed Americans without health insurance, another 13 million nonemployed Americans do not have health insurance. Mandated benefit programs obviously do not reach these people. There is certainly a case for public provision in situations where there is no employer who can be required to provide benefits.

A more fundamental problem comes when there are wage rigidities. Suppose, for example, that there is a binding minimum wage. In this case, wages cannot fall to offset employers' cost of providing a mandated benefit, so it is likely to create unemployment. This is a common objection to proposals for mandated health insurance, given that a large fraction of employees who are without health insurance are paid low wages. It is not clear whether this should be regarded as a problem with mandated benefits or minimum wages. Note that a payroll tax on employers directed at financing health insurance benefits publicly would have exactly the same employment displacement effects as a mandated health insurance program.

A different type of wage rigidity involves a requirement that firms pay different workers the same wage even though the cost of providing benefits differs. For example, the cost of health insurance is greater for older than for younger workers and the expected cost of parental leave is greater for women than men. If wages could freely adjust, these differences in expected benefit costs would be offset by differences in wages. If such differences are precluded, however, there will be efficiency consequences as employers seek to hire workers with lower benefit costs. It is thus possible that mandated benefit programs can work against the interests of those who most require the benefit being offered. Publicly provided benefits do not drive a wedge between the marginal costs of hiring different workers and so do not give rise to a distortion of this kind.

Another objection to mandated benefits is that they reduce the scope for government redistribution. Consider the example of old-age benefits. Many of the arguments I have discussed could be used to support a proposal to privatize Social Security. The principal problem with this proposal is that it would make the redistribution of lifetime income that is inherent in the operation of the current Social Security system impossible. Assuming perfectly flexible markets, wages for each type of worker would fall by the amount of benefits they could expect to receive from a mandated pension; there would be no transfer from poor to rich. If the government sought to prevent redistribution by preventing wage adjustments, unemployment among those most in need would result. The nonredistributive character of mandated benefit programs is a direct consequence of the fact that, as with benefit taxes, workers pay directly for the benefits they receive.

A different sort of objection to mandated benefits as a tool of social policy follows along the lines of the traditional conservative position that "the only good tax is a bad tax." If policymakers fail to recognize the costs of mandated benefits because they do not appear in the government budget, then mandated benefit programs could lead to excessive spending on social programs. There is no sense in which benefits become "free" just because the government mandates that employers offer them to workers. As with value-added taxes, it can plausibly be argued that mandated benefits fuel the growth of government because their costs are relatively invisible and their distortionary effects are relatively minor.

IV. Conclusions

The thrust of this analysis is that mandated benefits are like public programs financed through benefit taxes, thus saving many of the inefficiencies of government provision of public goods. There is an additional difference, however, in that mandated benefits typically allow more choice to employers and employees than public provision. From this perspective it is not surprising that conservatives tend to prefer mandated benefits to public provision, as evidenced, for example, in proposals to privatize Social Security or in proposals in the 1970s to mandate employer health insurance as the "conservative" alternative to national health insurance. Nor is it surprising that liberals tend to prefer mandated benefits to no public action, but have some preference for public provision over mandated benefits.

There is no question that debates about mandated benefits will continue for some time. Despite their potential importance, the role of mandated benefits as a tool for providing social insurance has received relatively little attention from students of public finance. In future work, it will be desirable to examine more formally the conjectures put forth here. It would also be valuable to begin the task of assessing empirically the effect of various programs on wage and employment decisions.

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