Etceteras . . .

The Real Scandal of "Janitors Insurance"

E. FRANK STEPHENSON

The past year has brought extensive media coverage of apparent corporate wrongdoing. High-profile bankruptcies, such as Enron's, and the "perp walk" arrests of corporate officers have been most prominent, but attention also has been given to the practice of purchasing so-called janitors insurance on rank-and-file workers.

Although many companies provide life insurance as part of their employees' compensation packages, janitors insurance (also known as peasant insurance or corporate-owned life insurance) is not a benefit that companies provide to workers. The survivors of deceased workers do not benefit from janitors insurance payments, and most covered employees are unaware that their employers have taken out insurance policies on their lives. The *Wall Street Journal* reports that "policies [can] continue in effect after workers have quit, retired, or been laid off" (Francis and Schultz 2002, C1). Critics predictably view janitors insurance as unethical. Examples include Amitai Etzioni, who breathlessly calls it a "ghoulish practice" (2003, A13); Senator Jeff Bingaman, who claims it is "unfair to workers" (qtd. in Schultz and Francis 2002, A2); and the editors of the *Houston Chronicle,* who opine that it is "shockingly callous" ("Can't Abide" 2002, A34).

That firms might want to purchase life insurance on key corporate officers is obvious. The loss of a CEO or other high official to, say, a plane crash or a heart attack might leave a company without a key member of its leadership team. Just think of what the sudden loss of Jack Welch might have done to General Electric or of the succession turmoil that might have erupted at Disney in the wake of an unexpected loss of Michael Eisner. Janitors insurance, however, is different. An ordinary employee, no matter how hardworking and productive, is typically just one among thousands of people working for a large company. It is difficult, therefore, to see disruption in leadership or uncertainty in succession as a rationale for companies' insuring the lives of ordinary employees.

E. Frank Stephenson is an associate professor of economics at Berry College.

Note, too, that the expected return from insurance would make it unlikely that firms would want to insure workers as a routine business practice. After all, insurance is actuarially unfair: every dollar paid in premiums, on average over a large pool of insured workers, will return less than one dollar of benefits. (This observation is not a moral condemnation of insurance, which has to be actuarially unfair because insurance companies must cover their expenses for agents, offices, and so forth.)

If the loss of a rank-and-file employee would not be unduly disruptive to a large company and if insuring workers is not sensible in the ordinary course of business, why then would companies want to insure large numbers of workers? A cynical possibility is that companies might intend to kill off their employees and thereby to turn a profit by defeating the actuarial tables. Fortunately, employee murder has occurred only in an episode of *Law and Order*. The *Houston Chronicle*, however, has editorialized that janitors insurance policies might give "companies an incentive to neglect worker safety" ("Can't Abide" 2002, A34). And Erica Heath, writing in the *Rocky Mountain News*, offers up a scenario based on the Mel Brooks play *The Producers* in which the Max Bialystock character is turned into a corporate consultant who promises that he "can introduce some unique features to your workplace that OSHA will never figure out" (2002, 4B).

A more plausible explanation becomes apparent, however, when we remember that many seemingly irrational activities take place in response to government-created incentives. Why do dairy farmers produce millions of gallons more milk than people want to consume? Because the government offers them above-market prices to do so. Why do people continue to build houses in areas that are vulnerable to hurricanes, such as North Carolina's Outer Banks? In part, at least, because of the government's generous flood insurance and disaster relief policies. Janitors insurance, it turns out, is the same sort of thing.

The Internal Revenue Service treats income from janitors insurance policies as tax exempt. Given a corporate income tax rate of 35 percent, it is easy to see how companies can take out actuarially unfair insurance policies and still come out ahead because of the tax savings. (Until 1996, companies could even borrow against the accumulated value of their janitors insurance policies and treat the interest payments as a deductible expense.) Although critics of janitors insurance denounce it as a tax dodge that causes tax rates to be higher than they might be otherwise,[1] the true cost to society occurs because of the misallocation of resources. Instead of investing funds in a productivity-enhancing endeavor, such as upgraded machinery or equipment, companies devote resources to uneconomical insurance schemes.

But wait, as they say in the television commercials, there's more. Although many companies (including Proctor & Gamble, Wal-Mart, and Disney, according to the outraged Etzioni) have purchased janitors insurance policies, and banks seem to be especially fond of the practice. The *Wall Street Journal* reports that at least one-fourth

1. Francis (2003c) reports that janitors insurance policies are estimated to reduce federal government revenue by $1.9 billion per year.

of the six hundred publicly traded banks—including Bank of America, J. P. Morgan Chase, and Bank One—have purchased janitors insurance policies (Francis and Schultz 2002). Why might banks—which are probably no greedier than other companies—be even fonder of these tax-free policies than other corporations? Perhaps because of the unique regulatory environment in which banks operate. Out of concern for their solvency, banks are prohibited from owning other companies' stocks. Insurance policies, however, are often based on underlying investments in stocks, thereby providing banks a (wasteful) way around the prohibition of stock ownership. It may not be wise for banks to hold stocks, but an even worse arrangement is one in which banks can own stocks only through expensive, roundabout devices such as janitors insurance.

Contrary to Etzioni's objection that janitors insurance subjects employees to "screaming unethical conduct" (2003, A13), the real scandal of janitors insurance is not some harm it does to the workers, who have not paid any of the premiums and usually are unaware that they are part of their employer's insurance scheme. Instead, the real scandal is the existence of government policies that reward companies for engaging in activities that would not make economic sense otherwise. Etzioni and other critics should redirect their ire toward the tax laws that reward inefficient activities such as the purchase of janitors insurance.[2]

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2. *Postscript:* Moves are under way to curb the use of janitors insurance. A federal appeals court recently upheld the Internal Revenue Service's disallowance of $66 million in interest deductions for loans used to purchase janitors insurance; however, at least one other federal court has sided with companies that claimed such deductions (Francis 2003a). On a different track, several efforts have been made in Congress to tax corporate proceeds from janitors insurance (Francis 2003b). In a clear example of rent seeking, the American Council of Life Insurers opposes the legislation (Francis 2003b)—hardly surprising, given that corporate-owned life insurance has accounted for at least one-fourth of new insurance sales in recent years (Francis 2003c).