Statement [for] Distribution and Economics of Employer Provided Fringe Benefits: Hearings before the Subcommittee on Social Security and Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives

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The sponsors of current proposals have mostly failed or refused to say what revenues they would hold constant and have not presented any backuping up their claim. Bradley and Gephardt refuse to release data. Gaylor's data show that payroll and individual income taxes, but he fails to specify the nature of his corporate income taxes, which bear on individual receipts also. Kemp and Kasen hint that their bill is actually a revenue loser but still call it revenue-neutral. The evidence on DeConcini suggests his bill could be either neutral or a large revenue loser.

**SPECIAL REPORT**

More generally, bills that keep revenues constant for lower-income groups may do so by penalizing those who are poor and by shifting the well-off who appear to have low income for tax purposes. Even calculating that a bill is revenue-neutral remains a matter of which bear on individual receipts also. Kemp and Kasen hint that their bill is actually a revenue loser but still call it revenue-neutral. The evidence on DeConcini suggests his bill could be either neutral or a large revenue loser.

Chairman Pickle. Mr. Woodbury, with the Upjohn Institute.

STATEMENT OF STEPHEN A. WOODBURY, SENIOR RESEARCH ECONOMIST, W.E. UPJOHN INSTITUTE FOR EMPLOYMENT RESEARCH

Mr. Woodbury. Thank you, Mr. Chairman. I am delighted to be here. I should mention immediately that I speak for myself and not necessarily for the Upjohn Institute or Michigan State University with which I am also affiliated.

What I would like to do is simply summarize my written testimony and emphasize a few points. My comments will focus on three issues. First, the growth of fringe benefits and reasons for that growth. Second, fringe benefit coverage and the implications of that pattern of coverage for income distribution. And third, equity of the tax system and revenue losses that result from fringe benefit exemptions.

Everyone here is well aware of the dramatic growth of non-wage benefits during the post-World War II years. The fact of fringe benefit growth is simply not controversial. There is more controversy I believe over the causes of that growth. Several studies listed in my testimony have found convincing evidence that the favorable tax treatment of fringe benefits, that is their exemption from Federal income and payroll taxes has had a highly significant impact on employer provision of benefits.

Many readers of these studies and even one or two of the researchers themselves seem to have inferred from these studies that favorable tax treatment is the major—or even the only—cause of fringe benefit growth in recent years. I believe this is a serious error and for two reasons. First, the same studies also find that a variety of other factors have influenced fringe benefit growth; the growth of real incomes and the aging of the labor force deserve particular mention because they have increased right along with the marginal income tax rate. Further, they seem to have a positive effect on benefits of the same order of magnitude as do increases in the tax rate.

Second, I am less confident than some researchers that we have successfully separated the effects of rising real incomes from the effects of rising tax rates. This is a statistical issue I comment on more fully in my written testimony.

Why does all this matter? It matters I think because one of the most frequently used arguments against taxing fringe benefits is that by so doing employer-provided fringe benefits, health and retirement plans in particular, would be reduced or even would disappear. Statistical findings indicate this is simply not true. We would blunt one incentive and one incentive only for further growth of employer-provided benefits if we were to tax them.

The other forces behind fringe benefit growth would continue, however. Insurance and pension plans would still be a better buy when purchased through the employer. The work force would continue to age. Employers would still use deferred benefits as a means of reducing turnover. Real incomes would continue to grow. So we would not kill the goose that laid the golden egg and witness the demise of the voluntary fringe benefit system if we tax fringe benefits.

About the distribution of fringe benefits I want to make just one point. Taken as a whole voluntarily provided benefits do increase the inequality of the distribution of income. But there is one benefit, health insurance, that seems to be roughly proportionally distributed. Health insurance it seems neither greatly increases nor decreases the equality of the distribution of income.

Finally, a few words on the equity of the tax system and revenue losses that result from fringe exemptions. It is quite clear that the exemption of fringe benefits from taxation induces, introduces both vertical and horizontal inequities into the tax system. That is, those with greater ability to pay do not necessarily pay proportionately greater taxes. This follows from the fact that higher paid employees also receive a higher proportion of their total compensation as fringe benefits which they are not taxed. Also, two workers with the same total compensation may pay quite different tax bills if one receives only wage income whereas the other receives some fringe benefits. Finally, we are all acutely aware of the revenue losses resulting from the exemption of fringes.

The pure solution to these inequities and the revenue losses that result is the subject of all employer contributions to Federal payroll and personal income taxes. Because of the opposition such proposals would likely meet, and have met, a variety of proposals to tax one benefit, health insurance, have been put forward.

Taxing health insurance contributions is an alluring prospect and represents a step in the right direction, but suffers from two important defects I feel. First, if we want to improve the equity of the tax system health contributions should be the last benefit to be taxed. The reason again is that health contributions alone among voluntarily provided fringes are distributed roughly proportionally.

The second defect of capping health contributions alone—or any single contribution alone—is that such an approach opens the door to tax avoidance by substitution away from the newly taxed benefit and towards still untaxed benefits. Such substitution is more than merely an academic matter. It means the existing estimates of revenue gains resulting from taxing health contributions may be too high. I should mention we have no microeconomic evidence at this point on the degree to which pensions and health insurance are substitutes. But developing such estimates should be a high priority for research.

In short, to mitigate inequities in the present system a uniform tax treatment of all benefits is required. Also, based on my own research and that of others I am unconvinced that taxation of em-
employer contributions would result in disappearance or even reduction of fringe benefits.

I would therefore advocate a limit on the proportion of total compensation that could be provided without Federal payroll or personal income taxation. This plan is similar to the second part of the Munnell proposal, and it has three advantages. First, it is comprehensive. Second, it focuses on the proportion of total compensation, and so obviates the wrangling that has taken place over dollar sum caps on tax-free contributions to health insurance. Finally, it would have a minimal effect on workers and their benefits while it would forestall further erosion of the tax base.

Thank you.
Chairman Pickle. Thank you.

[The prepared statement follows:]

STATEMENT OF STEPHEN A. WOODBURY, SENIOR RESEARCH ECONOMIST, W.E. UPJOHN INSTITUTE FOR EMPLOYMENT RESEARCH*

THE TAX TREATMENT OF FRINGE BENEFITS: WHAT DO WE KNOW AND WHAT NEEDS TO BE LEARNED?

The rather frivolous designation that has been given to nonwage benefits—"fringe" benefits—tends to mask both the importance of these benefits to workers and the far-reaching implications of their favored tax status. For it is difficult to think of health care or retirement income plans as merely decorative, peripheral, or frilly parts of the compensation package in an age when health care services account for over five percent of national income and when over eleven percent of the population is aged 65 or over. Further, the employer-provision of these benefits affects a multitude of economic outcomes and behavior: the distribution of income and the equity of that distribution; the size of the income and payroll tax bases and the timing of retirement.

What follows is a necessarily selective review of the burgeoning economic research on nonwage benefits—specifically private pensions and health-insurance plans—and an equally selective summary of the lacunae in that research. The focus is on a few questions that are of immediate importance to policy: How much have nonwage benefits grown and why? Who is covered and what are the implications of the existing pattern of coverage for income distribution? What changes in the tax treatment of nonwage benefits would yield significant revenue gains, and what are the implications of these changes for the equity of the tax system? What is some of the significant effects of employer-provision of benefits on workers' behavior and how do these induced behaviors affect in turn other economic outcomes?

HOW MUCH, AND WHY, HAVE FRINGE BENEFITS GROWN?

It is by now a commonplace observation that nonwage benefits voluntarily provided by employers have grown dramatically in the post-World War II period. The Bureau of Economic Analysis estimates that voluntary nonwage benefits (that is, "other labor income," which includes employer contributions to all voluntary benefits such as pensions, profit-sharing, group health and life, workers' compensation, and supplemental unemployment) rose from 2.3 percent of private sector total compensation in 1948 to 10.3 percent in 1982. For the sample of companies surveyed by the Chamber of Commerce, voluntary contributions to health insurance, and has become more representative over the years. Note that, unlike the National Income and Product Accounts, profit-sharing is not lumped with pension contributions in the Chamber of Commerce data.

For these purposes, total compensation is defined as the sum of wages and salaries and other labor income—that is, excluding contributions to social insurance. (Social insurance contributions are included in the income and product accounts' measure of "compensation" in Table 6.5 of the accounts.)

It would therefore be of interest to study the changes in the distribution of income and the implications for the tax bases and tax rates faced by households. Several studies have confirmed the influence of all three of these factors on fringe-benefit expenditures and the share of total compensation that is classified as fringe benefits. In particular, increases in the marginal tax rate on wage income and increases in households' real incomes have been found to have strong positive influences on the provision of health, life, and pension benefits. That several independent researchers using various sources and somewhat varying empirical techniques should all arrive at similar conclusions is fairly persuasive. But I would like to sound at least one warning about the interpretation of these results, lest they be misconstrued. It should not be inferred from these studies that rising marginal tax rates are the only, or even the most important, cause of fringe-benefit growth.

* The views stated here are those of the author and do not necessarily represent the views of the W.E. Upjohn Institute.

1 U.S. Bureau of Economic Analysis, The National Income and Product Accounts of the United States (Washington, D.C.: U.S. Government Printing Office, 1981), Tables 6.15 and 6.16B and Survey of Current Business 63 (July 1983), Tables 6.15 and 6.16B. For these purposes, total compensation is defined as the sum of wages and salaries and other labor income—that is, excluding contributions to social insurance. (Social insurance contributions are included in the income and product accounts' measure of "compensation" in Table 6.5 of the accounts.)


growth. Correspondingly, it should not be inferred that if the favorable tax treat-
ment of fringes were abolished then fringe-benefit plans would disappear. I feel it is
important to make these points because I am less confident than some that we have
successfully separated the effects of rising incomes from the effects of rising marga-
mal tax rates on fringe provision. Not only have incomes and tax rates grown togeth-
er over time, but also in cross-section there is a close relation between the income
and the marginal tax rate faced by a household. This close relation poses problems
for econometric estimation. Although together, rising incomes and rising marginal
tax rates on wages income have surely accounted for most of the recent increases in
fringe benefits—my own estimate is that they account for nearly two-thirds of the
increase—it would be premature to say that rising marginal tax rates rather than
(pure) rises in income are the main factor.

Will pension and health contributions continue to grow as a proportion of total
compensation? My own conjecture is that they will, under the status quo or any
change in tax treatment that is under serious consider-
ation. Under the status quo, in the presence of rising income, some workers
already have some retirement income will be less willing to exchange additional
more workers will have become less willing to trade additional income today for additional
retirement income. The market for certain nonwage benefits is, in effect, becoming saturat-
ed.12

FRINGE-BENEFIT COVERAGE AND INCOME DISTRIBUTION

Fringe benefit coverage and payments made by employers vary greatly by indus-
try, occupation, sex, and race. Transportation, manufacturing, and mining have
been historically high-benefit industries, whereas services, trade, and construction
have offered relatively low benefits.13 Among occupations, the high-benefit occupa-
tions are as one might expect: managers and administrators, professionals and tech-
nical, craft workers, and certain operatives. Service, sales, and clerical occupations
are, also expectedly, the low-benefit occupations. Even among full-time and full-year
workers, women receive lower benefits and are less likely to be covered than men.
As for black-white differentials, blacks are somewhat less likely to be covered by
pension contributions and nonwage benefits (34.8 percent for blacks, 38.2 percent for
whites), and fringe benefits make up a smaller proportion of black than of white
workers’ total compensation.14

EQUITY OF THE TAX SYSTEM AND REVENUE LOSSES RESULTING FROM FRINGE EXEMPTIONS

If a larger proportion of the total compensation of high-earners workers is re-
ceived as nonwage benefits, as appears to be the case, then the exemption of those
benefits from payroll and personal income taxes is clearly a regressive aspect of the
tax system. That is, exemption of nonwage benefits violates the vertical equity pre-
cept. What is the proper level of exemptable fringe benefits? I propose an appro-
ach would stem what many observers believe to be an inefficient and exces-
sive use of the health care system which has led to inflation in that sector, and
would also raise considerable revenues.19 Placing a tax cap on health contributions has
some alluring features, and represents a step in the right direction, but the approach also suffers from two important
defects. First, if we want to improve the equity of the tax structure, health
insurance contributions should be the last benefit to be taxed to full or partially tax, not the first.
As noted above, insurance contributions, alone among voluntarily provided
fringes, are distributed roughly proportionately. Thus, taxing them would not serve
to improve the vertical equity of the tax structure—in fact, calculations by Taylor
and Wieleny show that the effects of a tax ceiling on health contributions would be
feared disproportionately by lower-income groups.21

The second defect of placing a tax cap on health contributions alone (or on any
single benefit alone) is that such an approach still leaves contributions to other non-
wage benefits untaxed and hence opens the door to tax avoidance by substitution
away from nonwage benefits with taxable income, and other fringe benefits. An even
more serious problem is that the estimates of revenue gains from such a comprehen-
sive tax, made by Sullivan and Gibson, are based on a variety of assumptions that
are not clearly stated and that may not be realistic. It seems to me that such a tax
approach would fail to improve the vertical equity of the tax structure in fact, calculations by Taylor
and Wieleny show that the effects of a tax ceiling on health contributions would be
feared disproportionately by lower-income groups.

13 The response to a change in the price of wage benefits can be decomposed by the Slutsky
equation as follows: ΔW = δW + (1−δ)ΔWΔW, where δ is the elasticity of demand for fringe with
respect to a change in the price of wages, k, is the share of compensation received as wages, s is the
elasticity of substitution between wages and fringe, and e is the income elasticity for fringe, which, for
fringe items such as the wage share of total compensation (k) falls, the
14 Even if the terms of trade between present income and retirement income continue to im-
prove through increases in social security benefits, coupled with exemption of pension contrib-
utions, given proportional improvements in those terms of trade will elicit ever smaller re-
sponses from workers.
15 Munnell (1984) comes to the same conclusion for pension and health benefits by a slightly
different route.
16 Calculations from The National Income and Product Accounts, op. cit.; and Survey of Cur-
rent Business (July 1983).
17 See Smeding (1983), tables 6.2 and 6.3. This discussion depends heavily on Smeding’s
useful paper.
18 Again, see Smeding (1983), Tables 6.6 and 6.7. Smeding’s findings are corroborated by the
findings of Taylor and Wieleny (1983) for health benefits, and of Kotlikoff and Smith (1983) for
pensions.
19 Sullivan and Gibson (1983) discuss the details of these proposals.
20 See Taylor and Wieleny (1983) for some estimates of the potential revenue gains.
attempted such measurement. But it is clear that the appeal of a tax-cap on health contributions would wane substantially if the possibilities for substitution between health and pension benefits are strong.

**SUMMARY AND DISCUSSION**

Several studies have found that the growth of fringe benefits is accounted for largely by the favorable tax treatment they have received, by increases in real income, and by the going of the labor force. Although most of these studies have made much of the influence that favorable tax treatment and increasing marginal tax rates have had on fringe growth, it would be a mistake to believe that tax treatment is the only cause of fringe-benefit growth, and an even bigger mistake to believe that fringes would vanish if the favorable tax treatment were removed. Insur ance and pension plans are a better buy when purchased through the employer, the institutions to provide benefits efficiently are in place, the work force will continue to age, employers will still make use of deferred benefits as a means of reducing turnover, and real income will continue to rise—for all these reasons, removing the favorable tax treatment of benefits would not kill the goose that laid the golden egg and lead to the demise of employer-provision of health and retirement benefits.

In addition, equity and fairness in the distribution of income and the efficiency of the tax burden suggest the experience of taxing benefits. Pensions and other deferred compensation in particular lessen the equality of the distribution of income, so that the failure to tax employer contributions to pension plans violates the ability-to-pay or vertical equity principle of taxation. Also, since individuals with similar levels of total compensation may receive quite different mixes of wage and nonwage benefits, the failure to tax nonwage benefits introduces horizontal inequities into the tax system.

Full or partial taxation of a single specific benefit (such as health-care contributions) is an unattractive alternative to full or partial taxation of all benefits, because of the possibility that employees could substitute away from the newly taxed benefit and into still-unsubsidized benefits (such as pensions). Thus, taxation only of health contributions would not greatly improve the equity of the tax system. Neither, it seems likely, would it raise the amounts of revenue that have been promised, as workers and employers would make adjustments in the benefits package so as to avoid taxation. Finally, taxation of a single benefit would fail to correct fully the resource-allocation problems that has resulted from sheltering fringes from taxation—all have in effect been subsidized forms of compensation in the past, and an ever-handed approach to their taxation is needed to mitigate the distortive effects of the current system.

Munnell (1984) has discussed several alternatives to comprehensive and full income and payroll taxation of all employer contributions for fringes. Her suggested "perhaps palatable" alternative, which would limit the proportion of total compensation that an employer could contribute without taxation, lies at least three advantages. First, it is comprehensive, treating all benefits equally. Second, it focuses on the proportion of total compensation obviates the sort of wrangling over double-bumped caps than has accompanied proposals to limit tax-free contributions to health insurance. And third, it would have a minimal (if any) immediate effect on workers and their benefits, while forestalling further erosion of the tax base. Some such solution is greatly needed to redress the resource misallocations and inequities that the favored tax status of fringe benefits have generated.

**REFERENCES**


**Chairman Pickle. Our final panelist is Gail Wilensky, director, Center for Health Affairs, and vice president, Domestic Division, Project HOPE.**

**STATEMENT OF GAIL R. WILENSKY, VICE PRESIDENT, DOMESTIC DIVISION, PROJECT HOPE**

Ms. Wilensky. I am vice president of the Domestic Division of Project HOPE. I am pleased to have this opportunity to speak to
DISTRIBUTION AND ECONOMICS OF EMPLOYER-PROVIDED FRINGE BENEFITS

HEARINGS

BEFORE THE

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