1985

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 case backing up their claim. Bradley and Gephart refuse to release data. Ouyre's data show that for payroll and individual income taxes, but he fails to specify the nature of his corporate surcharge, the effects of which bear on individual receipts also. Kemp and Kasten 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 gainer.

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. Third, equity of the tax system and revenue losses that result from fringe benefit exemption.

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 of fringe benefits 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 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 proportionally greater taxes. This follows from the fact that higher paid employees also receive a higher proportion of their total compensation as fringes on 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 fully or partially tax, not the first. 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 would obviate 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 appellation 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 services account for over five percent of national income and when over eleven percent of the population is aged 65 or older. Rather, the employer-provision of 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 equity of the tax system; the use (or overuse) of the health-care system 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 are 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 funds 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 fringe benefits in general rose from 3.8 percent of payroll in 1950 to 26.2 percent in 1980.

* 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 6.1F. 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.)

2 See Rice (1969), Lester (1967), and Long (1962). But the most comprehensive study of this question is that of Rice and Scott (1968). This study shows that the growth of fringe benefits has been highest in the manufacturing and construction industries. Further, the growth of fringe benefits is positively correlated with the growth of real wages and with the level of employment.

3 Freeman and Mincer (1980) and Mincer (1981) offer an empirical treatment of the determinants of fringe benefits. These studies find that the growth of fringe benefits has been highest in the manufacturing and construction industries. Further, the growth of fringe benefits is positively correlated with the growth of real wages and with the level of employment.

4 Other "agreed upon" items rose from about five percent of total compensation in 1950 to 11.6 percent in 1982.

5 In large part, these increases have been in the form of contributions to retirement (and particularly health-insurance) plans. Studies of what were once called voluntary contributions were in the form of retirement and health benefits in 1948, nearly 84 percent of voluntary contributions were for retirement and health benefits in 1982.

6 Although no one disputes the enormous of nonwage compensation, there is less certainty about the causes of this growth. The literature of research on nonwage benefit includes: preferential treatment under the federal personal and corporate tax codes; economies of scale in the provision of pensions and insurance; efforts to improve workers' productivity and reduce turnover by deferring payment of benefits; unionization; changing demographic composition of the labor force; and rising real incomes.

7 To what degree can each of these factors explain the growth of fringe-benefit provision? Although the evidence is substantial, it does not point to a positive independent effect of the tax treatment of nonwage benefits. There are indications that the increase in the use of group insurance and the growth of voluntary pension arrangements are the result of the growth of nonwage benefits. Further, it is unclear that the "market" for fringe benefits is the same as the "market" for health insurance.

8 Deferral of income has been shown quite convincingly to reduce labor turnover, and by reference, to improve productivity. But again it is unclear that the desire to reduce turnover has been important to the growth of nonwage benefits. The only existing study of this question concludes that considerations of productivity and turnover are far less potent explanators of pension growth than is the tax treatment of pension contributions.

9 The most likely causes of fringe-benefit growth, then, are the aging of the labor force, favorable tax treatment of benefits, and rising real incomes (that is, increases in income apart from the implications such increases have for the tax rates faced by households). Several studies have shown that the influences of all three of these factors on fringe-benefit expenditures and the size of the tax base on the growth of nonwage benefits. In particular, increases in the marginal tax rate on wage income and increases in household's real incomes have been found to have strong positive influences on the provision of health, life, and pension benefits.

10 It should be noted that these studies were conducted using various techniques and somewhat varying time periods. However, the results of these studies are quite consistent. 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 provision. The views stated here are those of the author and do not necessarily represent the views of the W.E. Upjohn Institute.
growth. Correspondingly, it should not be inferred that if the favorable tax treatment of fringes was abolished then fringe-benefit plans would disappear. I feel it is important to point out that I am less confident than some that we have successfully separated the effects of rising incomes from the effects of rising marginal tax rates on fringe provision. Not only have incomes and tax rates grown together 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) raises in income are the main factor.

Will pension and health contributions continue to grow as a proportion of total compensation? My own confidence is that they will, and the status quo or any change in tax treatment that is under serious consideration. But the growth will almost surely be less dramatic than it has been in the past. Although the calculations leading to this guess are best relegated to a footnote, the intuition behind the guess is straightforward: Consider two workers with equal total compensation. One has a larger share of his compensation as deferred income and insurance benefits, whereas the other works a larger share of his compensation as fringe benefits. The reason is that health and life insurance benefits tend to be progressive distributed and bring about greater equality. For example, suppose that the sum of the wage benefits untaxed, and hence opens the door to tax avoidance by substitution from health benefits into pension benefits would take place; no study has yet been made of this substitution from health benefits into pension benefits would take place; no study has yet been made of this.

**Fringe-Benefit Coverage and Income Distribution**

Fringe benefit coverage and payments made by employers vary greatly by industry, occupation, sex, and race. Transportation, manufacturing, and mining have been historically high-benefit industries, whereas services, trade, and construction have offered relatively low benefits. Among occupations, the high-benefit occupations are as one might expect: managers and administrators; professional and technical, 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 compensation and pension 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. As a whole, voluntary employer-contributions to pensions and to health and life insurance tend to make the distribution of income more unequal: high-wage workers receive a larger share of their total compensation as deferred income and insurance benefits than do low-wage workers. But it is important to decompose the total compensation into health and life insurance, on the other hand, and other deferred compensation and pension benefits. The other reason is that health and life insurance benefits are roughly proportionately distributed (Smeeding found that insurance benefits ran from 3.7 percent of compensation for low-wage workers to 5.2 percent for a middle-wage group, and then declined to 2.9 percent for the highest earnings group) whereas deferred compensation is highly regresively distributed (0.4 percent of compensation for the lowest earnings group to 7.2 percent for the highest).

In contrast, legally required contributions, such as social security, unemployment insurance, and workers' compensation tend to be progressively and bring about greater equality. Voluntarily provided fringe benefits, unlike legally mandated contributions to social insurance, seem to have a disqualifying influence on income distribution. This naturally raises questions about the desirability of exempting these benefits from federal payroll and personal income taxes.

**Equity of the Tax System and Revenue Losses Resulting from Fringe Exemptions**

If a larger proportion of the total compensation of high-earnings workers is received 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 principle that those with greater income and gains should pay more in total taxes. Exemption of nonwage benefits creates situations where horizontal inequities can—and undoubtedly do—arise. Consider two individuals, each with identical income and earnings. One is an employer and offers a variety of compensation (wages plus contributions to health insurance, life insurance, and pension plans) of $20,000. Suppose also that they are both single and declare one exemption and the zero-bracket amount. If Smith receives $17,000 in wages, while Jones receives $18,500 in wages, then Jones pays more taxes than faces a higher marginal tax than Smith. But this clearly violates the precept of horizontal equity—there is no equality under this approach, and the health insurance benefit would be taxed.

The “pure solution” to this problem, as Munnell has called it, is to include all employer contributions for employee benefits in taxable gross income. (Increases in accrued pension contributions would also be included in gross income, since the increase in cost is a part of the individual’s lifetime income.) The pure solution is attractive both in principle—it would mitigate inequities in the tax system—and in the practical sense that it would either raise federal revenues or permit federal marginal income and payroll tax rates to be reduced. But the increase in cost would also raise considerable revenues. 20
attempted such measurement. But it is clear that the appeal of a tax-capped system 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 greater mistake to believe that fringes would vanish if the favorable tax treatment were removed. Insurance 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 distribution of the tax burden suggest the expedience 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-untaxed benefits (such as pension). Thus, taxation of the newly taxed benefit and into still-untaxed benefits 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 misallocation that has resulted from sheltering fringes from taxation— all have in effect been subsidized forms of compensation in the past, and an even-handed approach to their taxation is needed to mitigate the distorting effects of the current system.

Munnell (1984) has discussed several alternatives to comprehensive and full income and payroll taxation of all employer contributions for fringe benefits. Her suggested "perhaps palatable" alternative, which would limit the proportion of total compensation that an employer could contribute without taxation, has at least three advantages. First, it is comprehensive, treating all benefits equally. Second, its focus on the proportion of total compensation obviates the sort of wrangling over dollar-sum cuts 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 K. 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...
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