Fringe benefits

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A variety of forms of compensation that are not taxed.

For the purposes of tax policy, the most useful definition of fringe benefits is voluntary employer expenditures on noncash forms of compensation. If taxes were paid on comprehensive income, the form in which employees receive compensation would not affect their taxation. Indeed, the Internal Revenue Code (Section 61) defines gross income as including "all income from whatever source derived" and specifically notes that "compensation for services" is part of gross income. However, many fringe benefits are excluded from taxable income. These exclusions have implications for efficiency and equity and represent some of the largest tax expenditures in the U.S. tax system, totaling more than $100 billion.

History

The U.S. income tax has always excluded some forms of compensation from the individual income tax base, while employers have always been allowed to deduct the cost of fringe benefits as well as wages from their taxable incomes. Employer contributions for accident and health insurance plans were nontaxable in the original income tax in 1913, although there was some ambiguity about the tax status of fringe benefits until the Internal Revenue Code of 1954. Similarly, term life insurance premiums became tax-exempt in 1920 and deferred compensation plans received favorable tax status in 1921.

By the early 1980s, several other fringe benefits had received statutory exclusions: up to $5,000 of death benefits, parsonage allowances, certain benefits provided to members of the Armed Services, meals and lodging for the convenience of the employer, group legal services, commuting through van pools, dependent care assistance, and employee educational assistance. The statutes governing van pooling and educational assistance expired in the mid-1980s. Many other miscellaneous fringe benefits had always been untaxed even without statutory provisions; the Tax Reform Act of 1984 formalized the exclusions of any miscellaneous fringe benefits that meet one of five criteria: a no-additional-cost service, a qualified employee discount, a working-condition fringe, a de minimis fringe, or a qualified tuition reduction. Special rules were written for parking, eating, and on-site athletic facilities.

Beginning in the 1970s, employers began providing fringe benefits in the form of cafeteria or flexible benefit plans whereby employees could choose from a menu of several compensation options, including cash and several fringe benefits. These fringe benefits were made nontaxable in 1978. A related approach is the flexible spending plan, or salary reduction arrangement, which allows employees to set aside pretax dollars to spend on certain expenses (mostly health and child care) not covered by existing benefit plans.

Most of the statutory fringe benefits receive tax preferences only if provided in a nondiscriminatory manner, dating back to 1942, when nondiscrimination rules governing pensions were instituted. Other important limits are the $50,000 limit on the amount of term life insurance that can be provided tax-free to employees, the various restrictions and funding rules for pension and stock plans initiated by the Employee Retirement Income Security Act of 1974, and nondiscrimination and plan qualification rules for health and life insurance plans.

Fringe benefits as a share of total compensation were quite low until the three decades after World War II, when there was a rapid expansion. This expansion was caused by an increase in the number of fringe benefits offered as well as increased employer contributions to the traditional benefit plans. Rapid growth of fringe benefits as a form of compensation stopped around 1980.

The tax advantage to employees of receiving fringe benefits depends on marginal tax rates. Because most fringe benefits are excluded from the federal, state, and Social Security tax bases, the tax price of fringe benefits (that is, the amount of after-tax wages that would be given up for a dollar's worth of fringe benefits) is considerably less than $1. Since 1980, the tax price has risen slightly as federal and state marginal tax rates have fallen. Because higher-income taxpayers generally have higher marginal tax rates, they receive a greater advantage.

Efficiency effects

Not taxing fringe benefits gives rise to a consumption inefficiency because the goods that are provided as fringe benefits are made cheaper by the tax code. In this respect, health insurance has received the most attention. Many economists believe that the tax preference encourages more comprehensive health insurance to be provided and contributes to rising health care costs as consumers are shielded from the direct costs of their medical care.

The tax preferences given pensions and other deferred compensation plans may have an effect on national saving, although the effect is ambiguous because the tax preferences *ceteris paribus* lead to a larger government budget deficit. In addition, other forms of private saving may be affected by the amount of saving done in the form of pensions.

Tax preferences for fringe benefits may also have important effects in labor markets. The cost of labor is reduced differentially across firms and individuals, because the tax benefits increase with higher marginal tax rates. This effect may differ across workers, and some firms have cost advantages over others. Moreover, if employee preferences for fringes vary with skill levels, firms that use the skills of workers with a stronger preference for fringe benefits disproportionately may have lower costs than firms using other skill levels.

Because fringe benefits are tied to jobs, when compensation is paid in the form of fringes, labor mobility may be reduced, although this has some good as well as bad effects. Some kinds of fringe benefits, notably pensions, can also affect the timing of retirement as well as quitting behavior.

The labor market effects of not taxing fringe benefits depend greatly on whether employees sort themselves into firms based on their differing demands for the fringe benefits. Because the nondiscrimination rules that accompany the tax breaks given to fringe benefits mean that employers cannot tailor their fringe benefit offerings to each of their employees' wishes, heterogeneous preferences for fringe benefits should lead to a sorting equilibrium where some firms offer generous fringe benefit packages and others offer few or no fringes. Some firms are also more likely to replace the part of their workforce that do not want fringes with independent contractors, leasing arrangements, and part-time workers in order to satisfy the nondiscrimination rules. If workers are not perfect substitutes for each other, this leads to production inefficiencies. Sorting also exacerbates the adverse selection problem accompanying some fringe benefits such as health insurance, because less healthy workers will tend to congregate in firms offering more generous health insurance packages.

The importance of the distortions caused by the tax preferences given to fringe benefits depends on three things: the incidence of the tax preferences, the extent of job sorting that takes place, and the size of the effect tax preferences have on the amount of fringe benefits offered. Investigation of all of these issues is hampered by data problems.

Economic theory strongly suggests that the incidence of fringe benefit costs, and thus the incidence of tax preferences as well, is borne by the workers. Most of the arguments made in public debate about fringe benefits, however, are clearly based on the presumption that employers bear the costs (and receive the tax benefits). Statistical evidence has been inconclusive, although more and more studies are finding significant tradeoffs between wages and a variety of fringe benefits (consistent with employee incidence).

Empirical evidence regarding whether workers sort into jobs on the basis of fringe benefit offerings is meager. There seems to be support, though, for the hypothesis that some sorting occurs.

The relationship between tax incentives and the provision of fringe benefits has been the subject of many studies, although the data problems outlined earlier plague this research as well. There is some evidence that favorable tax treatment has led to an increase in the number of employees who receive various kinds of fringe benefits. There is also agreement that the tax advantage from paying compensation in the form of fringes rather than wages affects the share of fringes in total compensation. The magnitude of this effect, however, is uncertain. The results of some studies imply that full taxation of fringe benefits would cut by half or more the share of compensation paid in the form of fringes. Other studies find much smaller effects, with the fringe share of compensation falling by less than 15 percent if benefits were taxed fully.

Should fringe benefits be taxed?

Tax preferences are usually justified on the grounds of economic efficiency, equity (horizontal and vertical), or administrative efficiency.

Tax preferences for fringe benefits may improve economic efficiency if private markets lead to an underprovision of the fringes as a result of market failures. Indeed, there has been definite congressional intent to encourage the private provision of many of the goods typically provided as fringe benefits. Economists, however, seem more concerned with the distortions caused by the tax preferences than with the market failures they might correct.

Horizontal equity has received much attention in the debate about taxation of fringe benefits. A common argument is that tax subsidies for fringes are horizontally inequitable because two workers with identical total compensation will pay different amounts of tax if one receives more compensation as wages and the other more fringe benefits. But the disparity may be more apparent than real if workers choose their mix of wages and fringes by sorting themselves among employers who provide different ranges of fringe benefits.

The impact on vertical equity also depends on the incidence of the tax preferences. If employers are able to appropriate the benefits, few would argue that vertical equity is improved. If employees receive the benefits, the issue is whether more benefits are received by well-off taxpayers or poorer taxpayers. Because the tax savings resulting from the tax preferences increase with marginal tax rates, this by itself suggests that taxing fringe benefits would improve vertical equity. Evidence also suggests that well-paid employees are more likely to receive a higher fringe share of compensation than low-paid workers, although there is some evidence that moderate-income workers receive a higher fraction of their compensation as health insurance than do high-income workers.

There is also some evidence that low-income workers respond more to tax incentives than do high-income workers, so it could be that taxing fringe benefits would lead low-income workers to receive far fewer fringes while high-income workers would still receive them. This might have important social consequences if fringe benefits provide goods that society values and that the government would provide if private markets did not.

One reason that fringe benefits have been excluded from the tax base is concern over the administrative complexity for the government, employers, and employees of including the value of fringe benefits as part of taxable income. Part of this complexity is simply the paperwork; another important element is uncertainty about the proper valuation of the benefits. While the employee's willingness to pay for the fringe benefit is theoretically the best measure of value, employer cost is administratively much easier (although it may be difficult for firms to allocate their total costs to individual workers properly).

Proposals to tax fringe benefits

Three kinds of reforms of the tax treatment of fringe benefits have been proposed: limits on the amount of benefits that can be received tax-free, tax credits for some percentage of the value of the fringes as a replacement for the tax exclusion of fringes, and employer-based taxes. All of these options would reduce the tax benefits from receiving compensation in the form of fringes rather than wages.

Limits, or caps, on the amount of benefits that can be received tax-free would tend to improve efficiency and vertical equity by eliminating the tax benefits of fringes received by high-income taxpayers while retaining the tax benefits for those who do not receive as much of their compensation in the form of fringes. Because of the way that life insurance and pension benefits are valued, older workers would be especially hard hit by these limits. Also, because the costs of providing identical fringe benefits may differ substantially by region and industry, a single limit for all taxpayers may not be optimal. If limits are placed on specific benefits, other benefits would likely be substituted for them. To avoid this kind of response, a limit on the overall amount of compensation provided as tax-free benefits is an attractive option. Replacing the exclusion of fringe benefits with a tax credit could also improve efficiency and vertical equity. The credit would work better for fringes that are currently entirely excluded from the tax base than for fringes such as pensions, whose tax benefits are based on deferral of taxation.

Taxing employers instead of workers would be administratively less costly while still somewhat reducing the tax benefits of fringe benefits.

Conclusion

Many economists and tax experts think that some form of taxation of fringe benefits would be desirable. They believe that both efficiency and equity would be improved. Potentially large amounts of revenue could be raised, which could be used to finance new government spending, lower other taxes, or reduce the government budget deficit. Public opposition is strong, however, and there is no indication that any reform will be enacted soon.

Additional readings

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Cross references: employee stock ownership plan; health expenditures, tax treatment; horizontal equity; pensions, tax treatment; profit-sharing plans; vertical equity.