The American Workplace 2005:

The Changing Nature of Employee Benefits

EMPLOYMENT POLICY
FOUNDATION

Foreword

Foreword and Executive Summary

Foreword

For over 50 years, many Americans have had their health and retirement secured by the voluntary benefits that their employers have sponsored. Part I of *The American Workplace 2005* looks at the attempts employers are making to maintain those benefits for future generations of workers. Faced with increased foreign competition, spiraling health care costs and an aging workforce, employers are being forced to make difficult decisions that have a direct impact on the quality of their workers' lives and on their own ability to survive.

It would be incorrect to assume that employees are the only ones who have gained from employee benefits. While it is true that these benefits have greatly enhanced the lives of Americans, they also have substantial rewards for employers who have offered them. Health insurance helps to ensure a healthy workforce that arrives daily and performs at peak levels. Retirement plans inspire employee loyalty, reducing turnover costs and increasing employee tenure. Employers offer an array of benefit options both because they help them to attract and retain a highly qualified workforce and because they improve their employees' economic well-being. As these benefits become more expensive and begin to threaten the very existence of the firms that offer them, many of them are unhappy with the choices they face and want to continue offering the benefits that their employees desire. In the end, firms must remain profitable in order to provide their employees these benefits and, ultimately, jobs.

This, the tenth edition of *The American Workplace*, looks at the underlying demographic and cost trends that have resulted in the challenges that employer face in providing benefits today. These trends make it unlikely that America's employers can continue indefinitely to shoulder the cost of the benefits programs they have in place. Innovative thinkers have developed some programs that are seeking to better equip workers to make informed decisions about their health care. This includes information about the cost and success of different treatment options that is readily accessible and more transparent than that provided today. The purchasing power of America's large employers may be the force necessary to drive the medical industry to adopt these new standards.

In addition to demographic and cost challenges, the cost of benefits can be affected by legislative and regulatory action. Those who make the nation's laws would be well served to keep in mind the other factors affecting employer costs when making changes to the framework on which benefit plans are based. Proposed changes must consider carefully the effect that those modifications will have on employers who are responsibly funding their benefit obligations. Increasing the cost of benefits for those who currently provide them risks undermining the very programs that legislators and regulators are likely trying to secure.

Part II of the report, "Factbook on U.S. Workplace Trends," is a closer look at the success America has enjoyed so far and the challenges it faces in the future. These challenges are closely related to the employer-provided benefits discussed in Part I of *The American Workplace 2005*. Slowing labor force growth means fewer employees are available to spread the cost of benefit plans across. Slower population growth, combined with stable college graduation rates means fewer college graduates to replace those about to retire. Tuition reimbursement benefits have the potential to help boost the number of college graduates to help fill the need left by retiring baby boomers.

The American Workplace 2005 should provide a guide to policymakers, human resources professionals and the public as they examine and evaluate the changing nature of employee benefits and develop strategies for the future. This edition of *The American Workplace* could not have been possible without the contributions of the EPF Staff—Mike Chittenden, Danielle Maxwell, Hugh Saunders and Will Shields.

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Executive Summary

Many of today's employee benefits became commonplace over time as firms worked to hire and retain top talent. As employers sought to circumvent World War II-era wage controls, an inadvertent outgrowth of the tax code allowed employers to provide employee health insurance tax free, resulting in the system of health benefits currently in place. A desire to keep seniors from living in poverty led to the development and expansion of the pension plans offered by large employers in the twentieth century. What were widely referred to as "fringe" benefits are today no longer on the "fringe," but instead make up an important part of the employee compensation picture. Employees are now likely to weigh a benefits package just as heavily as salary when considering a career move. Unions and employers clash as frequently over proposed changes to benefits as they do over pay schedules and job stability. Employee benefits have grown to become a large part of most employers' budgets—accounting for an ever-larger portion of total employee compensation.

Today, a series of challenges is confronting employers as they seek to continue to offer quality benefits to their employees. Demographic, economic, regulatory and legal forces have worked to raise the costs of benefit plans resulting in a marked shift in the composition of labor compensation. Unlike growth in wages and salaries, over which an employer exercises control, growth in benefit costs is becoming less predictable over time with fewer levers on which firms can act to control spiraling costs. These challenges have left employers struggling with the dilemma of how to balance the need to control the cost of benefit plans with the need to attract and retain top talent.

Part I of *The American Workplace 2005* examines trends in employer-sponsored benefits and how those benefits are changing. The first chapter examines trends and issues in employer-provided health benefits. Chapter One also examines how employers are attempting to address the challenge of rapidly rising health benefit costs and still provide a benefit that is highly valued by their employees. Chapter Two discusses employer efforts to change the nature of retirement plans—including defined benefit plans, defined contributions plans, hybrid plans and retiree health insurance—to meet the needs of a changing workforce. Additionally, the chapter discusses recent legal challenges to some employer efforts to make changes to their retirement benefits. Chapter Three includes trends in other employer-provided benefits, such as paid leave, disability protection, life insurance and flexible work arrangements. Part II of *The American Workplace 2005* places the discussion of benefit trends in context. It provides an overview of the condition of today's American workplace and highlights the continuing economic recovery since 2001 in terms of output, employment, compensation and productivity.

Findings of *The American Workplace 2005* on the changing nature of benefits include:

Health Care Benefits

- Health care costs are growing at unsustainable rates, increasing 8.2 percent in 2004—nearly twice as fast as overall growth in the economy.
- By 2020, health care expenditures could consume nearly one-third of our nation's output—$6 trillion annually.
- The United States currently spends nearly twice as much, per capita, on health care care year year as our major trading partners—$4,631 in the United States compared to $1,765 in the United Kingdom and $2,535 in Canada.
- Efforts to increase cost-sharing with employees have focused largely on increases in the share of premiums paid and only more recently on copayments, coinsurance and deductibles. This has resulted in health insurance where medical consumers pay little at the point-of-service. While employees contribute 15 percent, on average, to premiums for single coverage, they contribute only a little more than 10 percent of health care costs for copayments and deductibles today as compared to 30 percent three decades ago. As a result, consumers have no incentive to be active participants in the process. Patients have little reason to be conscious of the cost of their medical care, its medical necessity or its effectiveness.
- The existence of "rich" health care benefits and low out-of-pocket payments have fueled demand for the best and often most expensive health care services, even in cases where they are not medically necessary.

Health Care Cost Containment Strategies

- To contain spiraling costs, employers have turned, in the short term, to increasing copayments and deductibles incrementally. Long-term efforts to control costs include a focus on consumer driven health plans (CDHP) that correct market inefficiencies and disease management plans to better engage consumers in making health care decisions.
- Health savings accounts (HSA) offer tax advantages on saving for high deductible health care plans and incentives to accumulate funds and roll over into next year.
- Only 10 percent of firms are currently offering CDHPs. Another 27 percent of employers are likely or somewhat likely to offer CDHPs with HSAs over the next two years.
- A lack of transparency in health care prices and the absence of reliable data on quality of care for each health care provider make it difficult for consumers to make adequate health care choices.

- Employers are increasingly turning to disease management programs that attempt to keep employees from contracting diseases that account for large portions of health care spending. Today, only 10 percent of individuals are responsible for 60 percent of health care costs. Currently, 51 percent of firms have adopted some form of disease management programs and another 30 percent are planning to do so over the next year. Nearly two-out-of-three employers believe disease management programs are effective at controlling costs.

Traditional Defined Benefit Plans

- Pension income represents a significant source of income in retirement. Among retirees with a pension, it constitutes 40 percent of their retirement income.
- Only 20 percent of workers are covered by a defined benefit pension plan, while over 40 percent of workers are covered by defined contribution plans—which represents a reversal of the trend twenty years ago. This shift from defined benefit to hybrid and defined contribution plans (discussed later) reflect a combination of the changing nature of the workforce, a near doubling of administrative costs and growing legal challenges.
- Smaller firms are finding it increasingly difficult to spread rising administrative costs across a small number of workers. Between 1990 and 2004, the number of firms with fewer than 1,000 employees offering a defined benefit plan declined by 70 percent.
- Large employers have been experiencing pension woes caused largely by declining equity values (which have reduced the assets of corporate pensions) combined with falling interest rates (which have increased the present value of future liabilities). Between 2000 and 2004, the number of firms with 1,000 or more employees offering a defined benefit plan declined by 16 percent.
- At the same time, a few high profile bankruptcies have left the Pension Benefit Guaranty Corporation, the federal insurer of defined benefit pensions, with a deficit of $23 billion in 2004.

Hybrid Pension Plans

- By 2003, one-fourth of large employers with defined benefit plans converted to hybrid pension plans, which combine features of both defined benefit and defined contribution plans. Most importantly, unlike traditional defined benefit plans, hybrid plans offer a portable benefit that employees can maintain when they change employers.
- The increased labor force participation of women—who tend to enter and exit the workforce more frequently than men—has highlighted the need for a more portable benefit—similar to that found in hybrid pension plans.

- Hybrid pension plans benefit a more mobile workforce. A worker who holds three or more jobs would receive a benefit 18 percent higher under a cash balance plan (one form of a hybrid plan) than if they had chosen to stay in a traditional defined benefit plan.
- Evidence suggests that employers are shifting to hybrid plans to adapt to the changing nature of the workforce and not necessarily to lower pension expenses.
- Unfortunately, growth in hybrid conversions has slowed substantially in recent years as increased regulatory and legal uncertainty has arisen around these plans. Unless these legal issues are resolved, they could jeopardize plan coverage for the 8.5 million workers who currently have hybrid pension plans.

Defined Contribution Plans

- In 2004, 42 percent of workers were covered by a defined contribution plan. These plans offer benefit portability to employees and lower administrative burdens to plan sponsors.
- Retirement income from a defined contribution plan depends on whether or not workers participate, the share of income or contribution rate they make and the rate of return on accumulated balances.
- Currently, 30 percent of workers eligible for a defined contribution plan do not participate.
- Since investment risk is borne by the employee, extended bear markets can adversely affect account balances, resulting in potential delays in retirement or shortfalls in retirement income.
- Because of a lack of knowledge, many defined contribution participants do not reallocate their assets following market changes or as they age, resulting in additional investment risk. Currently, employers cannot provide investment advice to employees without incurring a fiduciary responsibility for the employee's investments.
- Automatic enrollment programs and lifestage funds that shift assets into more conservative investments as employees near retirement are potential solutions for alleviating some of the shortcomings of defined contribution plans.

Retiree Health Insurance

- Retiree health benefits face many of the same economic and demographic pressures as traditional defined benefit plans. The cost of these benefits to employers has increased dramatically as medical costs have risen. As the baby boom generation begins to retire, the increase in the number of retirees will push many of these plans into a critical position.

- In an effort to control costs, an increasing number of employers have eliminated retiree health coverage for active employees—particularly new hires—while retaining coverage for current retirees.
- Current retirees have seen the nature of their benefits change as costs have escalated. Today's retiree health plans are more likely to cap employer premium contributions, tie premium contributions to years of service, and/or increase retiree cost sharing.
- Retiree health liabilities for Fortune 1000 companies amounted to over $500 billion in 2003 or 11 percent of stockholder equity. Current law does not provide tax advantages for employers to prefund these liabilities as they do with pension plans, thus these costs directly offset operating cash flow and reduce the profitability of firms.

Other Employee Benefits

- Paid leave is the most commonly provided employee benefit in the private sector and is available to 77 percent of employees. For a subcomponent of paid leave, vacation leave, employees average approximately 15 days of vacation (three working weeks) after they accrue five years of service.
- Workers in mid- to large-size firms are also eligible for unpaid leave under FMLA. EPF found that 14.5 percent of employees took FMLA leave over the past year.
- Nearly 70 percent of employees in medium to large firms receive life insurance from their employer. Of those with employer-sponsored life insurance, 58 percent receive coverage equal to their salary and another 25 percent receive twice their salary.
- Over 40 percent of employees in medium to large firms participate in a short-term disability program whose benefits typically cover up to 6 months of leave. Nearly 40 percent of employees participate in a long-term disability program.
- Flexibility can include a number of options such as scheduling of work (i.e. flextime and compressed workweeks) or alternate work schedules (part-time work or job-sharing). Sixty-two percent of employees in medium to large firms have access to flexible work schedules. Older workers are more likely to take advantage of flexible work schedules than younger workers.
- The increased labor force participation of women has led to a higher prevalence of employer-sponsored childcare and eldercare benefits. These benefits are aimed at helping workers better balance work and family matters. Thirty-two percent of employers offered childcare assistance in 2004 as compared to only 7 percent in the mid-1990s.

- As the workforce ages, more and more workers are being asked to help care for an aging parent or grandparent. Employers are helping workers identify and evaluate long-term care services through eldercare programs. Twenty-one percent of employees in medium to large firms have access to eldercare programs.
- Employer-sponsored long-term care insurance is also another fast-growing benefit. As older workers begin to take care of their own aging parents, many are looking to finance their own long-term care needs. The percentage of large and medium sized firms offering long-term care insurance to their employees increased from 20 percent in 2002/2003 to over 30 percent in 2003/2004.
- As college costs soar, an increasing number of college students must work full-time. Employers are helping workers obtain these degrees through tuition reimbursement programs. In 2002, as many as one in five university graduate students were receiving some form of tuition help from their employers.