CIVIL SERVICE REFORM III: PRIVATE SECTOR COMPENSATION PRACTICES

HEARING

BEFORE THE

SUBCOMMITTEE ON
CIVIL SERVICE

OF THE

COMMITTEE ON GOVERNMENT
REFORM AND OVERSIGHT
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

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CIVIL SERVICE REFORM III: PRIVATE SECTOR COMPENSATION PRACTICES

TUESDAY, OCTOBER 31, 1995

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CIVIL SERVICE,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 1:35 p.m., in room 2154, Rayburn House Office Building, Hon. John L. Mica (chairman of the subcommittee) presiding.

Present: Representatives Mica, Morella, Moran, and Holden.

Staff present: George Nesterczuk, staff director; Daniel R. Moll, senior policy director; Caroline Fiel, clerk; Cedric Hendricks, minority professional staff; and Elisabeth Campbell, minority staff assistant.

Mr. MICA. I would like to call this meeting of the House Civil Service Subcommittee to order. We have some Members who will be joining us, but they'll be deprived of my eloquent opening remarks. I'm going to start the hearing so we don't delay our panelists and witnesses.

Today's hearing is a continuation of this subcommittee's series of hearings on topics related to civil service reform. This is the third of four in the series. Today, we'll examine how the private sector structures its benefits and compensation packages to meet specific organizational goals.

Total compensation plays an important role in attracting and motivating any work force. The compensation issue is an integral part of overall civil service reform.

We're well aware of the administration's reform, as is evidenced by the "reinvention of government" agenda and the National Performance Review. We've worked closely with the Vice President on a number of his reform issues and feel we've received a positive response from the administration in looking at all of these issues, and in particular, compensation.

As we continue to downsize and restructure the Federal Government, we must not overlook the needs of our work force. At the same time, we have a responsibility to our citizens to ensure their government is more responsive, more accountable, and more effective.

The key to blending these requirements is to enable government agencies to recruit, motivate, and more effectively manage their employees. The manner in which compensation and benefits are structured has a dramatic effect on the ability of private sector companies to recruit, motivate, and manage their employees. There is no reason to believe that the public sector is any different.

Portability, flexibility, and greater employee choices appear to be the growing trends in benefit design throughout the private sector. This is in response to the priorities of today's more mobile workplace.

The field of private sector employee benefits is one of rapid and continuous change. Every budget bill passed by Congress since the mid-80's has included provisions affecting private employer-sponsored benefit programs. Private employers are also burdened by Federal regulations that spell out compliance requirements.

In addition to these dramatic changes, employers continually reevaluate benefit packages, not only for cost effectiveness, but also to respond to employees' needs. As people live longer and alter their lifestyles and patterns of work, their expectations change about what they need to ensure their economic stability.

The integration of benefit policy with both short- and long-range personnel planning is essential in the private sector. I think anyone who has dealt with the private sector knows that. Employers who deal with a more mobile work force will often dedicate a greater percentage of compensation to salaries and thereby reduce their level of benefits.

Those employers with a need to retain their work force over a longer period of time might structure a compensation package with a higher proportion of benefits, but temper this with vesting requirements to reduce turnover. Due to the realities of a highly competitive global marketplace, total compensation, combining high benefit levels with high salaries, is much more difficult to sustain today.

Federal compensation strategies are caught somewhere between the 1930's and 1940's when the focus was on job and benefit security, and the more mobile work force of today, with its focus on flexibility and portability. Somehow, we seem to be stuck in another era, at least in the public sector.

As the population ages and as corporations are facing increasing competition in the global marketplace and the needs of their employees change, the private sector is adapting its human resource management strategies. As Congress seeks to better allocate available resources within realistic budget constraints, it makes sense to revisit our own personnel management strategies, and that's what we're going to do here today.

To help the subcommittee explore these issues, we've convened two panels of witnesses today. Our first panel consists of Mr. Dallas Salisbury, president of the Employee Benefits Research Institute, who will present us with data on employers who have established their own human resource strategy and how they utilize that human resource strategy.

He will be followed by Jeannine Strandjord, vice chair of Employee Benefits at the Financial Executives Institute, who will examine some of the specific examples of benefit designs in individual companies. Ms. Strandjord is also a senior vice president at Sprint.

We have also, Mr. Peter Kelly, chairman of the U.S. Chamber of Commerce Qualified Plan Subcommittee, who will testify on the range of benefit packages offered by their members.

Our second panel will be led by Abe Zwany, who will testify on the basis of the Hay Group's consulting experience for private sector corporations. The perspective of Federal unions will be represented by the president of the American Federation of Government Employees, no stranger to our subcommittee, Mr. John Sturdivant. Our last witness is Wendell Cox, a consultant who will examine the relationship of private sector compensation practices to the public sector.

I look forward to the testimony of our witnesses today and hope that we can give a thorough examination of the options and various obstacles that confront private sector employers as we formulate employee benefit packages and look at alternatives for the Federal work force.

[The prepared statement of Hon. John L. Mica follows:]

Opening Statement of the Honorable John L. Mica
Chairman, Subcommittee on Civil Service
Hearing on Private Sector Compensation Practices
October 31, 1995

Good afternoon, and welcome to this hearing, a continuation of this subcommittee's series of hearings on topics related to civil service reform. Today we will examine how the private sector structures its benefit and compensation packages to meet specific organizational goals. Total compensation plays an important role in attracting and motivating any workforce.

Tackling compensation issues is a critical component of any serious effort to reform civil service. We are well aware of the Administration's interest in reform as evidence by the "reinvention of government" agenda in the National Performance Review. As we continue to downsize and restructure the federal government, we must not overlook the fuel that runs the engine of our workforce. We have a responsibility to our citizens to ensure their government is more responsive, more accountable , and more effective.

The key to blending these requirements is to enable government agencies to recruit, motivate, and more effectively manage employees. The manner in which compensation and benefits are structured has a dramatic effect on the ability of private sector companies to recruit, motivate, and manage employees. There is no reason to believe the public sector is any different. Portability, flexibility and greater employee choice appear to be the growing trends in benefit design throughout the private sector. This is in response to the priorities of today's mobile workforce.

The field of private sector employee benefits is one of rapid and continuous change. Every budget bill passed by Congress since the mid-1980's has included provisions affecting private employer-sponsored benefit programs. Private employers are also burdened by federal regulations that spell out compliance requirements. In addition to these dramatic changes, employers continually reevaluate benefits packages not only for cost effectiveness, but also to respond to employee needs. As people live longer and alter their lifestyles and patterns of work, their expectations change about what they need to ensure their economic security.

The integration of benefit policy with both short and long range personnel planning is essential in the private sector. Employers who deal with a more mobile workforce will often dedicate a greater percentage of compensation to salaries, and thereby reduce their level of benefits. Those employers with a need to retain their workforce over a longer period of time might structure a compensation package with a higher proportion of benefits, but temper this with vesting requirements to reduce turnover. Due to the realities of a highly competitive global marketplace, total compensation combining high-benefit levels with high salaries is much more difficult to sustain. Federal compensation strategies are caught somewhere between the 1930's and 40's with their focus on job and benefit security and the more mobile workforce of today with its focus on flexibility and portability.

As the population ages, as corporations face increasing competition in the global marketplace, and as the needs of their employees change, the private sector is adapting its human resource management strategies. As Congress seeks to better allocate available resources within realistic budget constraints, it makes sense to revisit our own personnel management strategies.

To help the Subcommittee explore these issues, we have convened two panels. Our first panel consists of Mr. Dallas Salisbury, President of the Employee Benefit Research Institute, who will present us with data that employers use to establish their human resources strategy. He will be followed by Jeannine Strandjord, Vice Chair of Employee Benefits at the Financial Executive Institute, who will examine some specific examples of benefit designs in individual companies. Mr. Strandjord is also a Senior Vice President at Sprint. Mr. Peter Kelly, Chairman of the U.S. Chamber of Commerce Qualified Plan Subcommittee, will testify on the range of benefit packages offered by their members.

Our second panel will be led by Abe Zwany, who will testify on the basis of the Hay Group's consulting experience for private sector corporations. The perspective of federal unions will be represented by the President of the American Federation of Government Employees, Mr. John Sturdivant. Our last witness is Wendell Cox, a consultant who will examine the relationship of private sector compensation practices to the public sector.

I look forward to the testimony of our witnesses and hope we can thoroughly examine the options and obstacles that confront private sector employers as the formulate employee benefit packages.

Mr. MICA. So, with those opening remarks, I will turn to Mr. Holden and see if he has any opening statement.

Mr. HOLDEN. Well, thank you, Mr. Chairman. I commend you for holding this hearing on civil service reform, and I look forward to hearing the testimony of the witnesses as we compare private sector compensation practices with that of the public sector. Again, Mr. Chairman, I thank you for holding this hearing, and I believe Mr. Moran will be with us shortly.

Mr. MICA. I thank the gentleman and now yield to the gentlelady, Mrs. Morella.

Mrs. MORELLA. Thank you, Mr. Chairman. In anticipation of this hearing being held on Halloween, I decided to bring a goody bag. Since the chairman was so gracious in offering us acorns at an earlier hearing, I figured today he would have some additional treats, such as "filet of fenny snake, in the cauldron boil and bake, eye of newt and toe of frog, wool of bat and tongue of dog, for a charm of powerful trouble, like a hellbroth boil and bubble." Sound a bit like Macbeth? [Laughter.]

Mr. MICA. Our specialty in this subcommittee is hellbroth. [Laughter.]

Thank you for your Halloween comment.

Mrs. MORELLA. Thank you. But, in all seriousness, I would really like to commend you, Mr. Chairman, for calling the hearing, and as I've said before, I'll say it again, that these hearings on civil service reform have been excellent thus far, and I'm certain that this hearing is going to yield some excellent information.

The issue of Federal employee compensation has created intense debate over the last few months. Members of this subcommittee have engaged in these debates and, in some cases, we've expressed very divergent views, yet we've all approached these debates with passion and compassion.

There will be change. I think all members of the subcommittee know that you cannot have true civil service reform without an integrated approach to the redesign of all human resource management systems, including the compensation system. But the necessity for change and the kind of change have always been at the crux of this issue.

I think I would get little argument if I said that a poorly conceived compensation system can have damaging and lasting effects on the government's ability to recruit and to retain a high quality work force. I believe that if you were to ask Federal workers what attracts them most to Federal service, behind service to their country, they would answer, the compensation package. So whatever we uncover today, we must understand its relationship to the Federal sector and its culture.

That's not to say that certain factors that dictate the creation or redesign of private sector compensation plans are not applicable to government. Economic concerns and demographic changes clearly affect both the private sector and the Federal sector. But what I am suggesting is that we recognize and appreciate the differences in private and Federal employment and seek to seamlessly integrate, not force, private sector principles into the framework of government.

I think, Mr. Chairman, that we will learn a lot from our witnesses today and look forward to the testimony. Thanks for calling this hearing.

[The prepared statement of Hon. Constance A. Morella follows:]

**STATEMENT OF THE
HONORABLE CONSTANCE A. MORELLA
HEARING ON CIVIL SERVICE REFORM III:
PRIVATE SECTOR COMPENSATION PRACTICES
SUBCOMMITTEE ON CIVIL SERVICE
OCTOBER 31, 1995**

In anticipation of this hearing being held on Halloween, I decided to bring my goody bag. Since the Chairman was so gracious in offering us acorns at an earlier hearing, I figured today he would have some additional treats.

But in all seriousness, I would like to commend Chairman Mica for calling this hearing. I have said before, and I will say it again, that these hearings on civil service reform have been excellent thus far, and I am certain this hearing will also yield good information.

The issue of federal employee compensation has created intense debate over the last few months. Members of this Subcommittee have engaged in these debates, and in some cases, we have expressed very divergent views. Yet, we all have approached these debates with passion and compassion.

There will be change. I think all the Members of this Subcommittee know that you cannot have true civil service reform without an integrated approach to the redesign of all human resource management systems, including the compensation system. But, the necessity for change and the kind of change have always been at the crux of this issue.

I would get little agrument if I said that a poorly conceived compensation system can have damaging and lasting effects on the government's ability to recruit and retain a high quality workforce. I think we must remember this in our deliberations. In fact, I believe that if you were to ask federal workers what attracts them most to federal service, behind service to their country, they would answer the compensation package. So whatever we uncover today, we must understand its relationship to the federal sector and its culture.

This is not to say that certain factors that dictate the creation or redesign of private sector compensation plans are not applicable to government. Economic concerns and demographic changes clearly affect both the private sector and federal sector. But what I am suggesting is that we recognize and appreciate the differences in private and federal employment and seek to seamlessly integrate, not force, private-sector principles into the framework of government.

I feel strongly we will learn a lot from our witnesses today, and I look forward to their testimony.

Again, I thank Chairman Mica for calling this hearing.

Mr. MICA. I thank the gentlelady and want to assure our panelists and our audience, for the record, that we don't intend to scare any Federal employees, and whatever hellboil we brew, we hope doesn't burn anyone. So with those Halloween comments in mind, we'll proceed and welcome our panel.

Our first panel is Dallas Salisbury, president of the Employee Benefits Research Institute, and Jeannine Strandjord. She is vice chair of the Employee Benefits, Financial Executives Institute; and Peter Kelly, for the U.S. Chamber of Commerce.

To our witnesses, this is an investigations and oversight subcommittee. It's the custom to swear in our panelists and witnesses, so if you'll stand and raise your right hands.

[Witnesses sworn.]

Mr. MICA. Thank you. The record reflects that they answered in the affirmative.

We'll start with your comments, Dallas Salisbury. I might add that you can submit an entire statement or commentary for the record. However, we like our panelists to summarize in about 5 minutes, and that gives us the opportunity for some discussion. With that you're recognized, Mr. Salisbury.

STATEMENTS OF DALLAS SALISBURY, PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE; JEANNINE STRANDJORD, VICE CHAIR, EMPLOYEE BENEFITS, FINANCIAL EXECUTIVES INSTITUTE; AND PETER KELLY, CHAIRMAN, QUALIFIED PLAN SUBCOMMITTEE, U.S. CHAMBER OF COMMERCE

Mr. SALISBURY. Mr. Chairman and members of the committee, it's a pleasure to be here this morning. I would ask that the full submission I've made be included in the record of the hearing.

Mr. MICA. Without objection, so ordered.

Mr. SALISBURY. Thank you. EBRI has been committed to working with the Congress, since its founding in 1978, on these issues. We took great pleasure in working with this committee and other committees of the House in the early 1980's, looking at private sector practices and their applicability to the public sector in redesigning the Federal Employee Pension Plan and in creation of the Federal Employee Thrift System.

Those changes, as well as much of what is taking place in terms of employment today and the criteria employers use, reflect some of what you said, Mr. Chairman, in your opening statement, that the bottom line is productivity.

The bottom line is a total compensation package that will be sufficient to attract, motivate, retain, and then, ultimately, to have individuals leave the work force at an appropriate point in time. Cash compensation, as with the Federal Government, is the base in all of these cases.

There has been an increasing movement in the private sector toward at-risk or incentive compensation being built on top of that basic cash compensation, and, as you noted, focus on a total benefits package that will provide for a healthy work force with low rates of absenteeism. This has been the primary motivator toward a very strong health insurance system in the private sector, as well as disability insurance.

If one looks at that from an employee perspective, surveys that we have taken over recent years through the Gallup organization indicate that if one asks a worker in the public or private sector, "If you can only have one benefit in addition to cash, what would it be?" approximately 75 percent always say health insurance benefits. In a survey released this last week by another organization, that number had risen to 86 percent preferring health insurance.

When asked about a second benefit, in both the private and public sector, you end up with about 22 percent saying retirement benefits, with an equal number saying a traditional defined benefit pension, as compared to those saying a more, if you will, new environment-defined contribution program, such as the Federal Employee Thrift Plan.

Employers also seek to design programs that allow individuals, as I noted, to retire or to exit from the work force. During the earlier age of paternalism and family owned enterprise in the private sector, these programs were primarily focused on those who were still working for an employer at the point of reaching retirement age.

Prior to the Employee Retirement Income Security Act of 1974, many enterprises only vested an individual in the pension at the point that they reached retirement age, and that was the vesting test.

Since ERISA has been in effect and recent changes that moved vesting in the private sector to 5 years, we've seen a significant change in approach and attitude of enterprises as, increasingly, they are focused on individuals and the accrual of benefits across the working lifetime and the fact that, with faster vesting, individuals may choose to leave at earlier points in time.

Employer recognition, as well, of economic and business instability and boom and bust cycles, has combined with full recognition of the cost of non-cash employee benefits and recognition of a highly mobile work force to move the employer focus from worker exit at retirement age to facilitation of worker exit whenever economic circumstances require—in essence, the process of reengineering, of right-sizing, of downsizing—and many employers in the private sector have increasingly found that that is most facilitated by a benefits structure with a great deal of choice.

Employer programs in the private sector do also vary significantly by the size of employers. The very smallest businesses in the Nation, if they provide any employee benefits other than cash compensation and vacation time, almost always provide, as a first benefit, health insurance, and, as a second benefit, some type of defined contribution retirement program.

As one moves to the largest businesses in our Nation, one most readily finds a combination similar to the Federal Government's—a relatively generous active worker health program, some approach to retiree medical benefit provision, a base-defined benefit pension plan augmented by a defined contribution program similar to the Federal Employee Retirement System, the thrift plan.

Cost in these companies also varies significantly with variation by size of the company. As would be anticipated, the smaller the enterprise, the less is spent on noncash compensation.

In an industry sense, goods-producing industries provide employees with benefits that are a much greater proportion of compensation than the newer service-producing industries, which have tended to focus far more readily on the existence of a younger labor force, relatively short product lives, and the need for the entity to adjust very quickly to changing market conditions.

This has ended up with more of a focus on enterprises wanting to be able to manage the work force from year to year with very limited focus on an issue of, if you will, ultimate retirement income provision.

As a result, major enterprises such as Microsoft Corp. and others in the high tech industry have a tendency to have relatively limited employee health insurance benefits, relatively generous 401(k) programs, and no other retirement programs of any type.

There are a number of central trends, then, in employee benefits today. First, a move to focus on incentive compensation above cash; second, the move that you mentioned, a focus on employee choice, employee flexibility, and employee responsibility.

A recognition that lifetime job tenure is something that was never there, for the vast majority of workers, was only taken full advantage of by, in the private sector, on average, 10 to 15 percent of workers, in the Federal civil service, only by about 23 to 25 percent of all those who entered the service, meaning that a traditional, paternalistic approach would only provide retirement income delivery for a small proportion.

More focus, as well, on employment as a function of the state of business versus a right of tenure. In the private sector, that is based on business cycles. In the public sector, one might view it as tied to deficits and unfunded liabilities. The rising age of the work force is influencing employers at this point, as well as they have come to focus far more readily on the cost of benefits and liabilities.

We've seen employers in the private sector move almost entirely away from cost of living adjustments and defined benefits pension plans, automatically providing them in basically no cases and increasingly making them much less frequent. We now look at data that says that about half of employers provide some post-retirement COLAs, but that number is declining.

We've seen in the retiree medical area, as a result of the Financial Accounting Standards Board and recognition of the cost of retiree medical benefits, a significant pull-back in the provision of retiree medical benefits.

In the pension area, we've seen announcements just this week of one major corporation, employing over 37,000 employees, announcing the change from a traditional defined benefit pension plan to a new individual account approach. Yesterday, a second company with 26,000 employees announced that they were freezing permanently their defined benefit pension plan and replacing it with a new 401(k) program which would become, in the future, the retirement income and savings vehicle for their work force.

I mention those two changes. They are significant, and they represent only 2 of approximately 10 major enterprises since 1974 that have made these types of changes, and they appear to be part of a growing movement.

Another realm that was asked about in your testimony was the growth of cafeteria plans and choice plans. So-called full cafeteria plans continue to be relatively, should we say, non-extensive, about 12 percent of private sector workers with full choice plans.

Flexible spending accounts have been, on the other hand, quite fast in growth, about 50 percent of private sector employees with so-called health care flexible spending accounts. For child care accounts, the State and local sector actually has more flexible spending accounts than does the private sector.

Finally, the issue you raised of taxation of private sector and the Federal role of benefits, employers have explicitly designed their programs over the years to take into consideration public programs and public policy. Direct integration with defined benefit and defined contribution plans relative to Social Security has always been present in the private sector, and increasingly so today.

Medicare has been reflected as a program to build around. Very few private employers provided any retiree medical benefits until Medicare came into existence in 1965. It is as Medicare has been cut back in the last 10 years and as discussions continue of cutting it back further that employers are cutting back their commitment, as well.

The dramatic growth of the 401(k) plans, the dramatic growth of health insurance, and flexible spending accounts are all examples of response to explicit tax incentives and an attitude of employers that if there is a tax advantage to the individual, then it is, in essence, an obligation of the employer to pass that tax preference on to the individual.

The revenue acquired through taxes to support public employee benefit programs has not had any direct impact on employers to date, but if we were to see significant increases in payroll taxes for pensions and Medicare, we could expect to begin to see some offset prospectively.

In conclusion, Mr. Chairman, I note that employers have spent decades building a structure of employment-based employee benefits to assist workers in planning lifetime economic security.

The end of paternalism in the wake of family control of enterprises and the rise of the global economy and global competition have begun to shape many changes in the private employee benefits system. As your invitation letter noted, the same is beginning to occur in the public sector workplace, particularly at the State and local level.

As the Congress deals with the future of Social Security, Medicare, public employee benefits, and issues such as tax reform, we can expect significant secondary effects on workers and the structure of their compensation packages. These changes may never be sufficient to stop legislative actions from being taken, but they should always be considered as policy is being designed and as implementation schedules are contemplated.

I very much appreciate the opportunity to appear today. It has been a pleasure to work with this committee for more than 20 years, and I look forward to that opportunity in the future.

[The prepared statement of Mr. Salisbury follows:]

STATEMENT OF DALLAS SALISBURY
PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI)
HEARING BEFORE THE HOUSE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT SUBCOMMITTEE ON CIVIL SERVICE
OCTOBER 31, 1995

Introduction

Mr. Chairman, I am pleased to appear before your subcommittee today to discuss the structuring of compensation and benefit programs in the private sector. My name is Dallas Salisbury. I am president of the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan public policy research organization based in Washington, DC. [1]

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

CHARACTERISTICS OF PRIVATE-SECTOR EMPLOYEE BENEFITS

Criteria Used To Establish Employee Compensation and Benefit Programs

- Employers seek to provide a total compensation package that will be sufficient to attract, motivate, and retain an appropriate work force for the particular functions that need to be accomplished while allowing the enterprise to operate without losses. Employers make use of a wide range of surveys to assess what this appropriate package is, and they ultimately market test the package: does it allow them to attract, motivate, and retain.
- Cash compensation is the base in all cases, with a movement in recent years toward a growing component of "at risk" or "incentive" compensation. For most of this century, profit-sharing plans have been a common form of at risk compensation, particularly for small businesses. Cash is the most important employee benefit, according to worker surveys.
- Employers also seek to have a healthy work force, with low rates of absenteeism. This has been the primary motivator in the continued sponsorship of health insurance and disability income benefits. Family coverage increases the likelihood that employees will remain at work when a family member has health problems and that health problems will not cause

[1] Mr. Salisbury joined EBRI as its first executive director in 1978. His previous assignments were with the Pension Benefit Guaranty Corporation; the Pension and Welfare Benefits Administration of the U.S. Department of Labor; the Office of the Deputy Attorney General at the U.S. Department of Justice; and the Committee on Elections and Reapportionment, Washington State House of Representatives.

financial disaster. Health insurance is the second most important employee benefit in the eyes of workers.

- Employers also seek to design programs that allow individuals to retire (work force exit). During the earlier age of paternalism and family-owned enterprise, these programs were primarily focused on those who were still working for an employer at the point of reaching retirement age. That has changed with the effective end of family ownership and management of large enterprise, combined with federal law that "vests" workers in the value of pensions as benefits accrue. Early vesting, which carried a high cost, caused employers to focus clearly on the relatively small number of full career workers they had, and the high rates of turnover among most workers. The complex web of legal and accounting standards that make it nearly impossible for an employer to promise retirement income or retiree health benefits without immediate understanding of what those benefits will cost has also led to change. The legally required move from pay-as-you-go to advance funding of pensions, and the accounting-motivated move for retiree health recognition, have caused a much greater focus on cost; significant redesign of benefit programs; and a growing recognition of the amount that individuals must save for themselves in order to achieve economic security in retirement.
- Employer recognition of economic and business instability (boom and bust cycles) has combined with full recognition of the cost of noncash employee benefits and recognition of a highly mobile work force to move the employer focus from worker exit at retirement age to facilitation of worker exit whe... ...ver economic circumstances require. This employment-at-will doctrine is changing the face of both employement and employee benefits. Many large private employers are only now at the stage of thinking through what this change means, as baby boomers move into senior management positions to replace those who grew up in the paternalistic work place. These employers are beginning to structure their benefit packages to conform with work force mobility. The "golden handcuff" pension plan is seldom seen as desirable as we progress into this new age of rewarding talent versus tenure.

Employer Costs Per Hour Worked for Employee Compensation in the Private Sector

Establishment Size

- In March 1995, wages and salaries averaged 71.6 percent of employer costs for employee compensation, while benefit costs averaged 28.4 percent (see table 1). Included in the 28.4 percent in benefit costs: 6.4 percent of compensation was in the form of paid leave, 6.7

percent was for insurance costs, 3.0 percent was for retirement and savings costs, and 9.3 percent was in the form of legally required benefits.

- As establishment size increases, the amount spent on wages and salaries as a percentage of total compensation decreases. In March 1995, 74.1 percent of employee compensation was in the form of wages and salaries for employers with 1–99 workers, compared with 71.3 percent and 68.8 percent for employers with 100–499 workers and 500 or more workers, respectively.
- As establishment size increases, the amount spent on benefits as a percentage of total employee compensation increases. In March 1995, for employers with 1–99 workers, 5.3 percent, 5.7 percent, and 2.3 percent of compensation was in the form of paid leave, insurance, and retirement and savings, respectively, compared with 6.2 percent, 7.0 percent, and 2.9 percent of compensation for employers with 100–499 workers. In establishments with 500 or more workers, 7.9 percent, 7.9 percent, and 4.0 percent of compensation was in the form of paid leave, insurance, and retirement and savings, respectively.
- In March 1995, employers with 500 or more workers contributed a significantly higher percentage of employee compensation in the form of paid leave (2.6 percent more) than employers with 1–99 workers.

Bargaining Status

- The wages and salaries compensation component is a smaller percentage of total compensation for union employers than for nonunion employers (see table 2). In March 1995, wages and salaries averaged 64.3 percent of employer costs for union employee compensation, compared with 73.2 percent for nonunion employers. Paid leave, insurance, and retirement and savings made up 6.9 percent, 10.0 percent, and 5.1 percent of total compensation for union employers, compared with 6.3 percent, 6.0 percent, and 2.6 percent for nonunion employers.
- In March 1995, union employers contributed a significantly higher percentage of employee compensation in the form of insurance (4 percent more) than nonunion employers.

Major Industry Group

- Service-producing industries provide wages and salaries as a higher percentage of total compensation than goods-producing industries (table 3). In March 1995, 73.5 percent of total compensation for service-producing industries was in the form of wages and salaries, compared with 67.3 percent for goods-producing industries.
- Goods-producing industries provide their employees with benefits as a greater portion of compensation than service-producing industries. In the goods-producing industry, paid

leave, insurance, and retirement and savings make up 6.6 percent, 8.0 percent, and 4.0 percent of total compensation, compared with 6.3 percent, 6.2 percent, and 2.6 percent for the service-producing industry.

TRENDS IN THE STRUCTURE OF EMPLOYEE BENEFITS

- There are a number of central trends in employee benefits today:
    1. More focus on incentive compensation, leading to the growth of profit sharing; at risk cash compensation; and equity ownership by employees.
    2. More focus on employee choice and responsibility, leading to the growth of participant-directed defined contribution savings plans; flexible spending accounts for health and dependent care; multiple option health plans; in some cases, cafeteria or total flexible benefit plans; and education regarding benefits choice tied to concepts of life-cycle stages and what the indiviudal must do for the individual.
    3. More focus on employment as a function of the state of the business versus a right to tenure, leading to a growing use of programs that were originally established as retirement plans as life transition resources that may be used at retirement but may also be used during periods of unemployment or reeducation. This trend has also entered the realm of Social Security, with defined benefit retirement plans being changed to "cash-balance" and other "hybrid" approaches that more readily conform to the realization that few workers who earn a benefit will still be with the employer at retirement age.
    4. The rising age of the work force is influencing employers. It is leading to an increasing focus on employee education regarding financial planning and retirement planning and education about taking full advantage of the programs that are being made available by the employer. It is leading to recognition of the implications of future demographics and future growth of the retiree population and is resulting in efforts to redesign programs to produce manageable future costs for retiree income and health programs. Future retirees who want postretirement COLAs will have to have saved enough in a defined contribution plan to make these payments to themselves. Retirees who want retiree medical protection will have to have saved money so they can afford the premium copayments and deductibles, as more employers facilitate the purchase of retiree health insurance but do not provide the money for the premiums during the postretirement period.

HEALTH INSURANCE

- Currently, a majority of workers receive health insurance through their employers.[2] Over 60 percent of nonelderly Americans participate in an employment-based health plan. The employment-based health system has been evolving since World War II, with employers being very active in the development and implementation of cost management strategies.
- Employers' use of cost management strategies in health care has become more prevalent as a result of the growth in employment-based health insurance, third party reimbursement, and technological advances. Responding to rising health care costs, employers have moved to managed care, which can be defined as any type of intervention in the provision of health care services or reimbursement of health care providers that is intended to provide health care services in the most efficient settings. These interventions not only include the movement of individuals into health maintenance organizations (HMOs) but also include increased employee contributions for health insurance premiums and increased cost sharing in traditional fee-for-service health insurance.
- Firms have been increasingly requiring workers to contribute to health insurance premiums and subjecting them to direct out-of-pocket provisions. In 1979, employers fully paid for single coverage health insurance for 73 percent of full-time workers employed in medium and large private establishments. By 1993, only 37 percent of workers had their individual coverage fully paid for. In 1979, employers fully paid for family coverage health insurance for 54 percent of full-time workers employed in medium and large private establishments. By 1993, only 21 percent of workers had their family coverage fully paid for.[3]
- There has also been a simultaneous increase in the cost-sharing provisions of traditional fee-for-service health insurance (table 4). In 1992, 26 percent of surveyed employers required a deductible of over $200, up from 11 percent in 1989. In 1992, 65 percent of employers required coinsurance of 20 percent for inpatient

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[2] In 1993, 54.2 percent of workers aged 18–64 received health insurance coverage from their employer. See Sarah Snider and Paul Fronstin, "Sources of Health Insurance and Characteristics of the Uninsured: Analysis of the March 1994 Current Population Survey," *EBRI Special Report* SR-28/*Issue Brief* no. 158 (Employee Benefit Research Institute, February 1995).

[3] U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in Medium and Large Firms*, 1979–1989 (Washington, DC: U.S. Government Printing Office, selected years); *Employee Benefits in Medium and Large Private Establishments*, 1991 and 1993 (Washington, DC: U.S. Government Printing Office, 1993 and 1995).

care, up from 62 percent in 1989. In 1992, 83 percent of employers required coinsurance of 20 percent for physician visits, up from 77 percent in 1989. In 1992, 26 percent of employers limited out-of-pocket expenses to between $1,500 and $2,499, an increase from 21 percent in 1989.

- Employers have increased their use of utilization review (UR) programs (table 5). These programs are designed to monitor the progress and appropriateness of health care services on a case-by-case basis. In 1992, 83 percent of surveyed employers required prior authorization for certain procedures, nonemergency hospital admissions, and elective surgery, up from 73 percent in 1989. In 1992, 66 percent of employers required health care to be monitored as it was provided and/or determined the length of a hospital stay and the scope of the treatment prior to treatment, up from 52 percent in 1989. Second surgical opinions were the only type of UR whose use decreased between 1989 and 1992.
- The use of HMOs has been one of the most prevalent methods utilized by employers to control rising health care costs. In 1980, there were 236 HMOs, with 9.1 million enrollees.[4] By 1994, there were 547 HMOs, with 43.4 million enrollees.[5] These plans range from staff models where the HMO owns its health care facility and employs health care providers on a salaried basis, to independent practice arrangements (IPAs), where groups of physicians practicing independently contract with an HMO to provide health care services to the HMO enrollees. The recent movement of individuals into HMOs has not been into the more controlled staff or group model HMOs but into the IPAs, where patients have a greater choice of physician. Between 1993 and 1994, there was a 42.6 percent increase in enrollment in mixed models, followed by a 7.6 percent increase in enrollment in IPAs. Group-based plans, i.e., staff, group, and network models, experienced a decline in enrollment between 1993 and 1994.
- Preferred provider organizations (PPOs) and point-of-service (POS) plans have also emerged as strong alternatives to fee-for-service plans and HMOs. The number of individuals enrolled in these arrangements increased significantly between the mid-1980s and today. Recently, the growth rate of enrollees in these plans has exceeded the growth rate of enrollees in HMOs because they allow greater choice of physician. Evidence on the savings from these plans is largely lacking but does

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4 Nancy Kraus, Michelle Porter, and Patricia Ball, *Managed Care: A Decade in Review 1980-1990* (Excelsior, MN: The InterStudy Edge, 1991).

5 The InterStudy Competitive Edge, 5.1 (Minneapolis, MN: Interstudy, 1995).

suggest there is a potential for savings. For example, AT&T was able to reduce its annual growth rates for medical expenses from 12.9 percent in 1991 to under 5 percent in 1992 because they moved their workers into POS plan. In 1991, the Pacific Telesis Group moved their fee-for-service enrollees into POS plans and reduced its annual growth rate from 12 percent to 5 percent. Surveys of their employees found that they were generally satisfied with the system once they understood it.

- In 1991, Cincinnati Bell, General Electric Aircraft Engines, Proctor and Gamble, and the Kroger Company formed a health care coalition to increase bargaining power for discounts with area hospitals, monitor quality improvements, and search for other ways to control costs. Annual savings in the Cincinnati area have been estimated at $75 million for all private and public payers of health care because of a 5 percent decrease in the average charge per patient and a 10 percent decrease in the average hospital length of stay.[6] This coalition has now grown to over 120 employers and a new agreement was just signed to provide for quality standards and a more coordinated community move to managed care.
- Coalitions have also been formed in Denver, CO; Memphis, TN; Cedar Rapids, IA; Houston, TX; Minneapolis, MN; Kingsport, TN; and many other cities. The activities of these coalitions have varied greatly, including the selection of preferred providers on the basis of efficiency, assistance in the purchase of cardiovascular care, the provision of mental health and substance abuse programs at reduced rates, the enactment of healthy lifestyle programs for adults and children, and the provision of small business insurance options. These coalitions are successful in reducing expenditures on health care because they create a competitive market with sound economic principles such as volume purchasing and competitive bidding.
- States have responded to growing health care costs not only as government entities but also as employers. The California Public Employees' Retirement System (CalPERS) has had success with its own purchasing cooperative for health care services. CalPERS experienced premium decreases in both 1994 and 1995 by negotiating more aggressively with health care providers and asking HMOs to forgo rate increases; the state introduced a standard benefits package in 1993, requiring copayments of its employees.

6Danae A. Manus, Robert J. Strub, and Thomas R. Werner. "The Cincinnati Initiative," *Managed Care Quarterly* (Winter 1994): 20–26.

- States have attempted to expand health insurance coverage and assure a minimum level of health benefits to the insured population by mandating the benefits that must be included in all health insurance policies issued in the state. State mandates do not extend to employers that self-fund their health insurance plans. The Employee Retirement Income Security Act of 1974 (ERISA) exempts self-insured plans from state benefit mandates.
- There is limited evidence that government mandated benefits that increase the cost of employing labor result in some form of cost shifting. One study found that several state and federal mandates that stipulated that childbirth be covered comprehensively in health insurance plans shifted the cost of those mandated benefits to workers in the form of lower wages.[7] Another study has also suggested that the increased costs of workers compensation were largely shifted to wages with little effect on employment.[8]
- The health care delivery and financing system is evolving rapidly. There have been changes in the way health care is financed, the types of treatments available, the sites of care, and the physician-patient relationship. These changes have resulted primarily from reactions to health care cost inflation, and employers' experiences in managing health care costs have varied with the methods chosen. We can expect to observe a continued increase in cost-sharing responsibilities of workers, the monitoring of care, the movement of workers and their dependents into managed care arrangements, especially those that offer greater choice of physician, such as IPAs, PPOs, and POS plans, and the formation of employer coalitions to negotiate for volume discounts for health care services.

Retiree Health Insurance

- The availability of health insurance for retired individuals is a growing concern of workers and employers. Ever-increasing health care costs and the Financial Accounting Standards Board's Statement No. 106[9] have caused many employers to reexamine their role in

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[7] Jonathan Gruber, "The Incidence of Mandated Maternity Benefits," *American Economic Review* (June 1994).

[8] Jonathan Gruber, and Alan B. Krueger, "The Incidence of Mandated Employer-Provided Insurance: Lessons from Workers' Compensation Insurance," in David Bradford, ed., *Tax Policy and the Economy* (Cambridge, MA: MIT Press, 1991).

[9] In December 1990, the Financial Accounting Standards Board approved Statement No. 106 (FAS 106), requiring many employers to record a liability for retiree health benefits on their balance sheet in order to comply with generally accepted accounting standards, beginning with fiscal years after December 15, 1992.

providing health benefits for current and future retirees. One survey shows that between 1988 and 1992, the percentage of large employers providing health insurance coverage to retirees declined from 62 percent to 52 percent (table 6). In addition, an increasing percentage of retirees now share the cost of their health insurance with their former employers.

RETIREMENT PLANS

Plan Type Trends

- While the number of private employment-based retirement plans and plan participants has been increasing, proportionately fewer are defined benefit plans and defined benefit plan participants.
- The total number of private tax-qualified employment-based plans (both primary and supplemental) more than doubled from 311,000 in 1975, when the Employee Retirement Income Security Act (ERISA) became effective, to 699,000 in 1991 (see table 7). The total number of private defined benefit plans increased from 103,000 in 1975 to 175,000 in 1983, then decreased to 102,000 in 1991. The total number of private defined contribution plans increased from 208,000 to 598,000 between 1975 and 1991.
- There is no evidence of a widespread "shift" from defined benefit to defined contribution plans. Although some plan sponsors, particularly small employers, have replaced defined benefit plans with defined contribution plans, such replacements are not driving the trends in defined benefit and defined contribution plans. Most large employer with more than 5,000 employees now have both types of plans.
- Almost three-quarters (73 percent) of the net decrease in the number of defined benefit plans involved very small plans, consisting of fewer than 10 active participants (see table 8). Between 1986 and 1990, there was a net decrease in the number of primary defined benefit plans of 67,995, and the net decrease in plans with fewer than 10 active participants was 49,700. Statistics from the Internal Revenue Service indicate that these trends have continued through 1995.
- Between 1985 and 1991, the net increase in the number of primary defined contribution plans with fewer than 10 participants was 66,594 plans; this accounted for 42 percent of the net increase of 160,052 in the number of primary defined contribution plans. Statistics from the Internal Revenue Service indicate that these trends have continued through 1995.
- The rapid growth in defined contribution plans cannot simply be explained by a replacement of defined benefit plans with defined contribution plans, because the net increase in defined contribution plans is far greater than the net decrease in defined benefit plans. Many

workers, particularly those in small firms, now have a defined contribution plan, very likely a 401(k) plan, when in the past they likely would have had no employment-based retirement plan. In addition, shorter service workers (the majority of the work force) will gain more benefit from a defined contribution plan than they would from a defined benefit plan.

Managerial Considerations

- Traditional defined benefit and defined contribution plans have their relative merits and drawbacks in terms of their use as management tools. Within legal and cost constraints, employers design pension plans to match their management goals for attracting a specific type of worker, retaining workers for a desirable time period, and encouraging them to leave or retire at a specified age or after a specified amount of time.
- Employers are able to provide employees with a moderate, but predictable, retirement benefit with a defined benefit plan because retirement income is independent of investment performance. In a defined contribution plan, even though employers can structure contribution schedules to meet target levels of retirement income, the actual benefits at the point of retirement, or separation from service, can be far below or far above the target, depending on the investment experience and the level of contributions.
- Defined benefit plans allow employers to influence retirement and job tenure by including specific provisions such as normal and early retirement age, benefits accruing after retirement age, and vesting schedules. Defined contribution plans are retirement neutral; they allow employers to influence job tenure through vesting schedules, but their ability to control retirement age is limited.
- In this era of continued corporate downsizing, employers often find it highly desirable to be able to reduce their work force on a voluntary basis by offering incentives through a defined benefit pension plan. Early retirement incentives are a more positive way to reduce the labor force than involuntary work force reductions. Employers desiring this type of retirement incentive flexibility through a qualified retirement vehicle are virtually forced to adopt a defined benefit plan as opposed to a defined contribution plan.
- In addition to encouraging retirement, pension plans may also be used to attract and retain employees. Employers attempting to attract younger, more mobile workers would be more likely to choose a defined contribution plan, while employers attempting to retain workers for longer time periods would be more likely to offer a defined benefit plan. Since benefits in defined benefit plans accrue at a slow rate for the initial years of service and accrue at faster rates for older employees with more service, they reward long-tenure employees. Defined contribution plans do not cause large benefit losses for mobile employees, assuming that each of their employers has an equally generous plan.

- Defined contribution plans are also easier to communicate, particularly to younger employees, because they are able to see their benefits accumulate in an account while working rather than being told they will receive a monthly income on retirement.
- Some employers choose to integrate pension benefits with Social Security in order to spend an equal amount, as a percentage of pay, on retirement benefits for all employees. Employers are able to integrate benefits with Social Security more effectively through defined benefit plans because the integration can be done by adjusting benefit formulas.
- Employers may have a philosophy about who should bear investment return and inflation risks. In a defined benefit plan, employers generally absorb the investment return risk by providing a specific benefit regardless of investment income. In a defined contribution plan, the employee bears the investment risk.
- Employers that have uncertain or volatile profits, such as small employers or new businesses, may prefer a defined contribution plan in order to have flexibility in contribution to the plan. Profit-sharing plans allow employers to use discretion in making plan contributions and are only required to contribute on a "substantial and recurring" basis. Defined benefit plans do not allow for as much flexibility in determining the level of plan contributions, and their actuarial determination depends on many factors that may be out of the sponsor's direct control, such as investment performance.
- Employers may use profit-sharing or company stock plans to improve productivity. Some 401(k) plans are also used to improve productivity by increasing the employer's matching contribution when profitability improves. These plans provide employees with direct incentives to increase productivity and identify more strongly with the employer.

Role of Work Force Demographics

- A change in work force patterns affects pension coverage to the extent that different types of employers are more likely to offer different plan types, and different types of employees prefer different plans.
- While a smaller percentage of employees in the service sector are covered by defined benefit plans than are covered by defined contribution plans, the number of participants in both types of plans increased between 1985 and 1989.
- While defined benefit plans have remained the primary form of pension coverage for a growing number of participants in large firms, a decrease in the proportion of workers employed in manufacturing and unionized industries and an increase in the proportion of workers employed in service industries should increase the role of defined contribution plans in providing retirement income.

- Small employers are less likely than large employers to offer pension plans and more likely to offer primary defined contribution plans if they offer a plan at all because they are faced with economic circumstances that often discourage them from sponsoring plans, particularly defined benefit plans. Perhaps the most important economic reason that fewer small employers offer plans is the overall lower compensation levels common to small employers.
- Lower paid employees typically face lower marginal tax rates than higher paid employees and therefore have less incentive to defer income and taxes. In addition, given competing current consumption needs, they may be reluctant to defer a substantial portion of their pay, whether as elective contributions to a 401(k) plan or as automatic employer contributions to some other type of plan. Small employers may in turn be ill-equipped to add retirement plan contributions on top of existing payroll, given tight or uncertain profit margins.
- Other economic factors inhibit retirement plan sponsorship, particularly sponsorship of defined benefit plans. Small employers, who pay lower wages, often employ less skilled employees who may be easier to replace. The employees may also be younger or more loosely attached to the labor force. Small employers would have little incentive to provide defined benefit plans to encourage a long-lasting employment relationship with unskilled workers. Moreover, because of gradual benefit accruals, vesting delays, and other plan design features, shorter-term employees generally tend to benefit less from retirement programs than do longer-term employees.
- As work force age demographics change, employers may need to alter their benefit programs to continue to attract the quantity and quality of workers they desire. According to Census projections, the proportion of elderly persons in the population will increase in the future as the baby boom generation ages.

CAFETERIA PLANS

- A cafeteria plan is a flexible benefit plan that offers an employee certain choices in accordance with Internal Revenue Code sec. 125. Cafeteria plans (which offer a wide range of benefit options/choices) must offer a combination of qualified nontaxable benefits (health insurance, sickness and accident insurance, long-term disability, etc.) and taxable benefits (or cash). Flexible spending accounts (FSAs) are another type of flexible benefit plan that may exist as stand-alone plans or within cafeteria plans. In an FSA, employees set aside money for qualified unreimbursed medical or dependent care expenses through pretax salary reduction in separate accounts. Employees choose how much money they want to contribute to an FSA at the beginning of the plan year, within limits. To the extent that these funds are not used for expenses incurred during the plan year, they are forfeited.

Availability of Cafeteria Plans

- There has been a small but steady increase in the percentage of cafeteria plans offered by employers. In 1993, 12 percent of full-time employees working in medium and large private establishments were eligible for cafeteria benefits, compared with 5 percent in 1988. Four percent of full-time employees working in state and local governments were eligible for cafeteria benefits in 1992, compared with 1 percent in 1987. Approximately 2 percent of full-time employees working in small private establishments were eligible for cafeteria benefits in 1992, up from 1 percent in 1990.[10]
- In recent years, FSAs (and to a limited extent cafeteria plans) have expanded in both the public and private sector (table 9). In 1993, 53 percent of full-time employees working in medium and large private establishments were eligible to participate in FSAs and/or cafeteria plans, compared with 13 percent in 1988. In 1992, 14 percent of full-time employees working in small private establishments were eligible to participate in FSAs and/or cafeteria plans, compared with 8 percent in 1990. Fifty-one percent of full-time employees working in state and local governments were eligible to participate in FSAs and/or cafeteria plans in 1992, compared with 9 percent in 1987.[11]

Cafeteria Plan Options

- According to a 1994 study by Hewitt Associates, the most common types of benefits offered under cafeteria plans were FSAs-dependent care (93 percent of employers offering cafeteria plans offered this benefit) and FSAs-health care (87 percent) (see table 10). Other common benefits offered under cafeteria plans include health plans choices other than HMOs (71 percent), death benefit choices (39 percent), and disability benefit choices (24 percent).[12]
- The greatest changes in benefits offered under cafeteria plans has occurred with health plan choices (other than HMOs) and spending accounts (dependent care). In 1994, 93 percent of employers who provided cafeteria plans offered dependent care spending accounts as an option, compared with 78 percent in 1987. In 1994, 71 percent of employers offered health

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[10]Employee Benefit Research Institute, *EBRI Databook on Employee Benefits*, Third edition (Washington, DC: Employee Benefit Research Institute, 1995).

[11]Ibid.

[12]Hewitt Associates, *Salaried Employee Benefits Provided by Major U.S. Employers*, 1988 (Lincolnshire, IL: Hewitt Associates, 1988).

plan choices (other than HMOs) as an option, compared with 94 percent in 1987 (Hewitt Associates, 1987 and 1994).[13]

- There has been a clear increase in the number of employers offering cafeteria benefits (and FSAs) to their workers. Employees working in medium and large private establishments are more likely than workers in small private establishments to be eligible for cafeteria benefits. The increase in availability of cafeteria benefits and FSAs is likely to continue. Contributing to the increase are the changing needs of a work force with large numbers of dual-earner families. In addition, flexible benefit plans are viewed as a way to help control the rising costs of health care, where duplicate coverage can be avoided.

TAXATION AND THE FEDERAL ROLE IN BENEFIT PROGRAMS

- Employers have designed their employee benefit programs around government mandated programs for decades. Pension plans—both defined benefit and defined contribution—have been integrated with Social Security to avoid excessive employer-funded retirement income. Disability insurance is integrated with Social Security disability, and health incurance is being integrated with workers compensation on an increasing basis as employers seek to manage total health cost. As government increases the age of benefit elegibility under Social Security and Medicare, and as it changes actual benefit levels, private programs will be adjusted.
- Tax treatment has been a driving force in the growth of employee benefit programs. When Congress has acted to allow a benefit to be provided to the worker, without the dollar value being treated as taxable income to the worker, employers have responded by putting the programs into place. The size and profitability of the business, as well as employees' relative earnings levels, lead to variation in sponsorship, but the responses are clear. Employers with primarily minimum wage employees are the least likely to respond to tax preferences and establish programs.
- The dramatic growth of 401(k) plans, the dramatic growth of health insurance, and flexible spending accounts, are all recent examples of the effect of new tax incentives. Were tax incentives eliminated so that all income (cash and in-kind) was taxable to the individual, dramatic changes in employer provision of employee benefits could be expected.
- The revenue required through taxes to support public employee benefit programs has not had any direct impact on employers in terms of the compensation packages they offer. The actual employee benefits provided to public-sector employees have created pressure for private employers to maintain programs in order to compete in the market place for workers. The

[13] Hewitt Associates, *Salaried Employee Benefits Provided by Major U.S. Employers*, 1988 and 1994 (Lincolnshire, IL: Hewitt Associates, 1988 and 1994).

future effect on employers will primarily come from the massive unfunded liability of public pension and retiree medical programs as they are paid for in the future.

- The revenue required to pay for Social Security and Medicare has had a major effect on total compensation packages and on the funds employers and workers have available for funding their own pension and retirement savings programs. Should payroll taxes continue to rise, employers and workers can be expected to cut back on private pension savings as well.

CONCLUSION

Employers have spent decades building a structure of employment-based employee benefits to assist workers in planning lifetime economic security. The end of paternalism, in the wake of the end of family control of enterprises and the rise of a global economy, have begun to shape many changes in the private employee benefit system. As your invitation letter noted, the same is beginning to occur in the public-sector work place. As the Congress deals with the future of Social Security, Medicare, public employee benefits, and issues such as tax reform, we can expect significant secondary effects on workers and the structure of their compensation packages. These changes may never be sufficient to stop legislative actions from being taken, but they should always be considered as policy is being designed and as implementation schedules are contemplated.

I very much appreciate the opportunity to appear today. It has been my pleasure to work with this committee for over 20 years, and I pledge the availability of myself and the Employee Benefit Research Institute in the years ahead as you seek to deal with these major economic issues.

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Table 1
Characteristics of Private-Sector Employee Benefits

Employer Costs Per Hour Worked for Employee Compensation, Private Industry, by Establishment Size, March 1990 and March 1995

Compensation Component	Total Private Industry		1–99 Workers		100-499 Workers		500 or More Workers	
	(in dollars)	(percent)	(in dollars)	(percent)	(in dollars)	(percent)	(in dollars)	(percent)
MARCH 1995								
Total Compensation	$17.10	100.0%	$14.58	100.0%	$16.30	100.0%	$22.85	100.0%
Wages and Salaries	12.25	71.6	10.81	74.1	11.62	71.3	15.72	68.8
Total benefits	4.85	28.4	3.77	25.9	4.68	28.7	7.13	31.2
Paid leave[a]	1.09	6.4	.77	5.3	1.01	6.2	1.81	7.9
Supplemental pay[b]	.47	2.8	.35	2.4	.51	3.1	.66	2.9
Insurance[c]	1.15	6.7	.82	5.7	1.14	7.0	1.80	7.9
Retirement and Savings[d]	.52	3.0	.33	2.3	.48	2.9	.91	4.0
Legally required benefits[e]	1.59	9.3	1.48	10.2	1.53	9.4	1.87	8.2
Other benefits[f]	.03	.2	g	g	.02	.1	.06	.3
MARCH 1990								
Total Compensation	$14.96	100.0%	$13.08	100.0%	$13.82	100.0%	$20.02	100.0%
Wages and Salaries	10.84	72.4	9.77	74.7	10.02	72.5	13.90	69.4
Total Benefits	4.13	27.6	3.31	25.3	3.81	27.5	6.12	30.6
Paid leave[a]	1.03	6.9	.74	5.6	.94	6.8	1.70	8.5
Supplemental pay[b]	.37	2.5	.30	2.3	.31	2.3	.57	2.9
Insurance[c]	.92	6.1	.69	5.2	.88	6.3	1.44	7.2
Retirement and Savings[d]	.45	3.0	.33	2.6	.39	2.8	.76	3.8
Legally required benefits[e]	1.35	9.0	1.25	9.6	1.28	9.3	1.61	8.0
Other benefits[f]	g	g	g	g	g	g	.04	.2

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employment Cost Indexes and Levels, 1975-1993* (Washington, DC: U.S. Government Printing Office, 1993)

[a] Includes vacation, holidays, Sick leave, and other leave.

[b] Includes premium pay, shift pay, and nonproduction bonuses.

[c] Includes life insurance, health insurance, and sickness and accident insurance

[d] Includes pensions and savings and thrift.

[e] Includes Social Security, federal unemployment, state unemployment, and workers' compensation

[f] Includes severance pay and supplemental unemployment benefits.

[g] Cost per hour worked is $0.01 or less.

Table 2
Characteristics of Private-Sector Employee Benefits

Employer Costs Per Hour Worked for Employee Compensation, Private Industry, by Bargaining Status, March 1988 and March 1995

Compensation Component	March 1988 Bargaining Status Union		Nonunion		March 1995 Bargaining Status Union		Nonunion	
	(in dollars)	(percent)	(in dollars)	(percent)	(in dollars)	(percent)	(in dollars)	(percent)
Total Compensation	$18.16	100.0%	$12.90	100.0%	$22.40	100.0%	$16.26	100.0%
Wages and Salaries	12.04	66.3	9.61	74.5	14.42	64.3	11.9	73.2
Total benefits	6.12	33.7	3.29	25.5	7.99	35.7	4.35	26.8
Paid leave[a]	1.35	7.4	.89	6.9	1.55	6.9	1.02	6.3
Supplemental pay[b]	.64	3.5	.26	2.0	.73	3.3	.43	2.6
Insurance[c]	1.45	8.0	.64	5.0	2.24	10.0	98	6.0
Retirement and Savings[d]	.87	4.8	.36	2.8	1.15	5.1	.42	2.6
Legally required benefits[e]	1.76	9.7	1.11	8.6	2.24	10.0	1.49	9.2
Other benefits[f]	.06	.3	g	g	.08	.3	.02	.1

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employment Cost Indexes and Levels, 1975-1993* (Washington, DC: U.S. Government Printing Office, 1993).
[a] Includes vacation, holidays, sick leave, and other leave.
[b] Includes premium pay, shift pay, and nonproduction bonuses.
[c] Includes life insurance, health insurance, and sickness and accident insurance
[d] Includes pensions and savings and thrift.
[e] Includes Social Security, federal unemployment, state unemployment, and workers' compensation.
[f] Includes severance pay and supplemental unemployment benefits.
[g] Cost per hour worked is $0.01 or less

Table 3
Characteristics of Private-Sector Employee Benefits

Employer Costs Per Hour Worked for Employee Compensation and Costs as a Percent of Total Compensation, Private Industry, by Major Industry Group, March 1987 and March 1995

Compensation Component	All Private Industry (in dollars)	All Private Industry (percent)	Goods-Producing[a] (in dollars)	Goods-Producing[a] (percent)	Service-producing[b] (in dollars)	Service-producing[b] (percent)	Manufacturing (in dollars)	Manufacturing (percent)	Nonmanufacturing (in dollars)	Nonmanufacturing (percent)
MARCH 1995										
Total compensation	$17.10	100.0%	$20.75	100.0%	$15.88	100.0%	$20.47	100.0%	$16.29	100.0%
Wage and salaries	12.25	71.6	13.97	67.3	11.67	73.5	13.72	67.0	11.89	73.0
Total benefits	4.85	28.4	6.78	32.7	4.20	26.5	6.74	33.0	4.39	27.0
Paid leave[c]	1.09	6.4	1.37	6.6	1.00	6.3	1.54	7.5	.96	6.0
Supplemental pay[d]	.47	2.8	.78	3.7	.37	2.3	.80	3.9	.39	2.4
Insurance[e]	1.15	6.7	1.66	8.0	.98	6.2	1.72	8.4	1.02	6.2
Retirement and savings[f]	.52	3.0	.82	4.0	.41	2.6	.75	3.7	.46	2.8
Legally required benefits[g]	1.59	9.3	2.08	10.0	1.43	9.0	1.86	9.1	1.53	9.4
Other benefits[h]	.03	.2	.07	.4	i	i	.09	.4	.02	.1
MARCH 1987										
Total compensation	$13.42	100.0%	$15.86	100.0%	$12.40	100.0%	$15.51	100.0	$12.80	100.0
Wage and salaries	9.83	73.2	11.12	70.1	9.29	74.8	10.77	69.5	9.55	74.6
Total benefits	3.60	26.8	4.74	29.9	3.12	25.2	4.73	30.5	3.26	25.4
Paid leave[c]	.93	6.9	1.09	6.8	.87	7.0	1.21	7.8	.85	6.6
Supplemental pay[d]	.32	2.4	.53	3.3	.23	1.8	.52	3.4	.25	2.0
Insurance[e]	.72	5.4	1.02	6.4	.60	4.8	1.06	6.8	.62	4.8
Retirement and savings[f]	.48	3.6	.64	4.1	.41	3.3	.58	3.8	.45	3.5
Legally required benefits[g]	1.13	8.4	1.43	9.0	1.01	8.1	1.31	8.5	1.08	8.4
Other benefits[h]	.02	.1	.04	.2	i	i	.04	.3	i	i

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employment Cost Indexes and Levels, 1975-1993* (Washington, DC: U.S. Government Printing Office, 1993).

[a] Includes mining, construction, and manufacturing.

[b] Includes transportation, communication, and public utilities; wholesale and retail trade, finance, insurance, and real estate; and service industries.

[c] Includes vacation, holidays, Sick leave, and other leave.

[d] Includes premium pay, shift pay, and nonproduction bonuses.

[e] Includes life insurance, health insurance, and sickness and accident insurance

[f] Includes pensions and savings and thrift.

[g] Includes Social Security, federal unemployment, state unemployment, and workers' compensation.

[h] Includes severance pay and supplemental unemployment benefits.

[i] Cost per hour worked is $0.01 or less.

Table 4

Percentage of Employers With Cost-Sharing Provisions, by Level of Cost Sharing and Year for Traditional Indemnity Plans

Individual Deductible Amount	1989	1990	1991	1992	1993	1994
$100 or less	40%	38%	34%	29%	29%	16%
$150	15	15	15	13	6	10
$200	29	27	28	28	29	34
Over $200	11	18	23	26	36	40

Coinsurance Rate		Inpatient Care			Major Medical	
	1989	1990	1991	1992	1993	1994
0%	23%	25%	27%	25%	6%	5%
10%	7	5	4	4	n/a	
15%	2	2	2	2	n/a	
20%	62	65	63	65	87	88
25%	a	2	1	1	n/a	
Other					7	8

Coinsurance Rate Physician Visits	1989	1990	1991	1992
0%	8%	6%	6%	5%
10%	6	5	4	4
15%	2	2	2	2
20%	77	84	82	83
25%	a	2	1	1

Employee Out-of Pocket Maximums	1989	1990	1991	1992	1993	1994
<$1,000	35%	37%	30%	28%	27%	21%
$1,000-$1,499	38	37	39	38	38	40
$1,500-$2,499	21	20	24	26	22	30
$2,500-$4,999	4	5	6	6	8	4
$5,000+	2	2	2	2	5	5

Source: A. Foster Higgins & Co., Inc., *Health Care Benefits Survey, Report 1: Indemnity Plans: Cost, Design and Funding* (Princeton, NJ: A. Foster Higgins & Co., Inc., 1990–1993).

[a]Data not available.

Note: Data for years 1989-1992 represent the full sample from the survey. Data for years 1993–1994 represent employers with 500 or more employees.

Table 5
Percentage of Surveyed Employers with Utilization Review Programs, Traditional Indemnity Plans, 1989–1994

Type of Program	1989	1990	1991	1992	1993	1994
Precertification of Elective Admissions	73%	81%	81%	83%	79%	80%
Concurrent Review	52	65	65	66	64	65
Catastrophic Case Management	55	65	67	69	68	80
Outpatient Utilization Review	19	20	19	22	36	36
Second Surgical Opinion	89	88	82	71	91	87
Mandatory[a]	59	55	49	45	40	44
Voluntary[b]	30	33	33	26	51	43
None of These	9	7	8	7	10	5

Source: A. Foster Higgins & Co., Inc., *Health Care Benefits Survey* (Princeton, NJ: A. Foster Higgins & Co., Inc., 1990–1993).

[a]For specific procedures.

[b]For all procedures.

Note: Data for years 1989-1992 represent the full sample from the survey. Data for years 1993-1994 represent employers with 500 or more employees.

Table

Retiree Contribution to Health Plan

Percentage of Surveyed Employers by Retiree Contribution to Health Plan for Retiree-Only Coverage, 1988–1993

	For Retirees Under Age 65:					For Retirees Aged 65 and Over:				
	Percentage of all Respondents Who Provide Coverage[a]	Percentage of Plans[b] in which			Average Contribution[c] as a % of Premium	Percentage of All Respondents Who Provide Coverage[a]	Percentage of plans[b] in which			Averge Contribution[c] as a % of Premium
		Employer pays all	Retiree pays all	Cost is shared			Employer pays all	Retiree pays all	Cost is shared	
Historial Trend										
Old scope										
1988	62%	38%	25%	37%	57%	55%	47%	21%	32%	57%
1989	60	36	20	44	51	52	47	17	37	52
1990	60	26	21	53	50	54	37	19	44	52
1991	56	37	23	40	55	49	48	19	32	56
1992	52	32	23	45	52	46	43	19	38	52
New scope										
1993	9	21	68	11	30	10	22	67	11	39

Source: A. Foster Higgins & Co., Inc., *Health Care Benefits Survey, 1992, Report 2: Retiree Health Care* (Princeton, NJ: A. Foster Higgins & Co., Inc., 1993) and *Tables: National Survey of Employer-Sponsored Health Plans, 1993* (Princeton, NJ: A. Foster Higgins & Co., Inc., 1994).

Note: In 1993, the survey sample design and methodology were changed. Because of these changes, the 1993 results are not comparable with those of past years.

[a]Other than as required under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA).

[b]Among respondents offering retiree health benefits.

[c]Among those requiring contributions.

Table 7
Trends in the Structure of Employee Benefits

Private Pension Plans and Participants

Summary of Private-Sector Qualified Defined Benefit and Defined Contribution Plans and Participants, 1975–1991

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
(thousands)																	
Total Plans[a,b]	311	360	403	443	471	489	546	594	603	604	632	718	733	730	731	712	699
Defined benefit[a]	103	114	122	128	139	148	167	175	175	168	170	173	163	146	132	113	102
Defined contribution[a]	208	246	281	315	331	341	378	419	428	436	462	545	570	584	599	599	598
Defined contribution as percentage of total	67%	68%	70%	71%	70%	70%	69%	71%	71%	72%	73%	76%	78%	80%	82%	84%	85%
(millions)																	
Total Participants[b,c]	45	48	50	52	55	58	61	63	69	74	75	77	78	78	76	77	78
Defined benefit[c]	33	34	35	36	37	38	39	39	40	41	40	40	40	41	40	39	39
Defined contribution[c]	12	13	15	16	18	20	22	25	29	33	35	37	38	37	36	38	39
Defined contribution as percentage of total	26%	28%	30%	31%	33%	34%	36%	39%	42%	45%	47%	48%	49%	48%	48%	50%	50%
Active Participants	31	32	33	34	35	36	37	37	39	40	40	41	42	42	43	42	43
Primary plan is defined benefit[d]	27	27	28	29	29	30	30	29	30	30	29	29	28	28	27	26	26
Primary plan is defined contribution[d]	4	5	5	5	6	6	7	8	9	10	12	13	13	14	15	16	17

Source: Employee Benefit Research Institute tabulations based on U.S. Department of Labor, Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin* (Winter 1995).

[a]Excludes single participant plans.

[b]Due to rounding, sums of individual items may not equal totals.

[c]Includes active, retired, and separated vested participants not yet in pay status. Not adjusted for double counting of individuals participating in more than one plan.

[d]For workers covered under both a defined benefit and a defined contribution plan, the defined benefit plan is designated as the primary plan unless the plan name indicates it provides supplemental or past service benefits.

Table 8
Trends in the Structure of Employee Benefits

Primary Plan Trends by Plan Size

Primary Defined Benefit and Defined Contribution Plan and Active Participant Trends, 1985–1991

	Primary Plans							Active Participants (thousands)						
	Defined Benefit Plan													
Active Participants	1985	1989	1990	1991	Net change 1985–1991	Net change 1989–1990	Net change 1990–1991	1985	1989	1990	1991	Net change 1985–1991	Net change 1989–1990	Net change 1990–1991
2–9	88,124	59,966	45,796	38,424	–49,700	–14,170	–7,372	353	246	189	168	–185	–57	–21
10–24	24,267	17,791	15,624	18,095	–6,172	–2,167	2,471	369	271	244	273	–96	–27	29
25–49	14,178	9,736	8,605	7,374	–6,804	–1,131	–1,231	491	340	304	255	–236	–36	–49
50–99	11,303	9,013	8,346	8,060	–3,243	–667	–286	808	645	599	585	–223	–46	–14
100–249	9,534	7,109	6,563	6,183	–3,351	–546	–380	1,498	1,135	1,040	979	–519	–95	–61
250–499	4,670	4,022	3,647	3,514	–1,156	–375	–133	1,651	1,430	1,293	1,245	–406	–137	–48
500–999	3,149	2,701	2,463	2,328	–821	–238	–135	2,222	1,910	1,751	1,655	–567	–159	–96
1,000–2,499	2,360	2,220	2,090	2,028	–332	–130	–62	3,636	3,434	3,221	3,119	–517	–213	–102
2,500–4,999	847	833	798	780	–67	–35	–18	2,930	2,940	2,802	2,704	–226	–138	–98
5,000–9,999	455	450	434	469	14	–16	35	3,141	3,153	3,015	3,261	120	–138	246
10,000–19,999	198	213	223	219	21	10	–4	2,749	2,956	3,134	3,134	385	178	0
20,000+	175	178	161	167	–8	–17	6	8,985	8,792	8,711	8,324	–661	–81	–387
None or None Reported	10,280	18,485	18,139	13,944	3,664	–346	–4,195	–	–	–	–	–	–	–
Total[a]	169,540	132,717	112,890	101,585	–67,955	–19,827	–11,304	28,834	27,252	26,303	25,701	–3,133	–949	–602
	Defined Contribution Plans													
2–9	199,704	334,762	266,129	266,298	66,594	–68,633	169	852	1,410	1,127	1,151	299	–283	24
10–24	70,424	107,113	97,054	99,188	28,764	–10,059	2,134	1,056	1,637	1,476	1,508	452	–161	32
25–49	31,406	48,351	45,737	49,132	17,726	–2,614	3,395	1,091	1,680	1,584	1,695	604	–96	111
50–99	17,620	29,997	27,446	29,528	11,908	–2,551	2,082	1,224	2,081	1,911	2,067	843	–170	156
100–249	8,878	13,334	13,658	13,890	5,012	324	232	1,331	1,991	2,071	2,117	786	80	46
250–499	2,552	3,599	4,144	4,314	1,762	545	170	868	1,239	1,428	1,488	620	189	60
500–999	1,185	1,675	1,838	1,952	767	163	114	808	1,151	1,266	1,345	537	115	79
1,000–2,499	784	1,148	1,103	1,169	385	–45	66	1,194	1,709	1,671	1,790	596	–38	119
2,500–4,999	219	265	310	325	106	45	15	752	907	1,072	1,124	372	165	52
5,000–9,999	97	107	130	126	29	23	–4	683	726	869	850	167	143	–19
10,000–19,999	34	59	44	47	13	–15	3	460	788	626	644	184	–162	18
20,000+	29	36	27	31	2	–9	4	1,100	1,329	1,151	1,361	261	–178	210
None or None Reported	13,082	38,839	40,473	40,067	26,985	1,634	–406	–	–	–	–	–	–	-
Total[a]	346,014	579,285	498,093	506,066	160,052	–81,192	7,973	11,420	16,647	16,251	17,141	5,721	–396	890

Source: Employee Benefit Research Institute tabulations of 1985, 1989, 1990, and 1991 Form 5500 annual reports filed with the Internal Revenue Service.

[a]Total may not equal the sum of individual items due to rounding.

Table 9
Trends in the Structure of Employee Benefits

Percentage of Full-Time Employees Eligible for Cafeteria Plans and Flexible Spending Accounts (FSAs): Medium and Large Private Establishments, 1988, 1989, 1991, and 1993: Small Private Establishments, 1990 and 1992; and State and Local Governments, 1987, 1990, and 1992

	Medium and Large Private Establishments[a]				Small Private Establishments[b]		State and Local Governments[c]		
	1988	1989	1991	1993	1990	1992	1987	1990	1992
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Providing Cafeteria Benefits and/or FSAs	13	24	37	53	8	14	9	32	51
Cafeteria Benefits with FSA	4	8	9	11	1	2	1	3	4
Cafeteria Benefits with no FSA	1	1	1	1	d	d	5	2	1
Freestanding FSA	8	15	27	41	6	12	3	28	46
Not Provided Cafeteria Benefits or FSA	87	76	63	47	92	86	91	68	49

Source: Employee Benefit Research Institute, *EBRI Databook*. Third edition. (Washington, DC: Employee Benefit Research Institute, 1995).

[a] These tabulations provide representative data for full-time employees in private nonagricultural establishments with 100 or more employees in the District of Columbia and all states except Alaska and Hawaii. In 1991 and following years, the survey includes establishments in Alaska and Hawaii.

[b] These tabulations provide representative data for full-time employees in private, nonagricultural establishments with fewer than 100 employees.

[c] The Bureau of Labor Statistics' survey scope was expanded significantly in 1990 to include part-time workers, all governments regardless of size, and Alaska and Hawaii. The former survey coverage, which included only full-time workers in government units employing 50 or more workers in the 48 contiguous states and the District of Columbia, is referred to as old scope. The expanded survey coverage is referred to as new scope. In this table, 1987 is old scope and 1990 and 1992 are new scope.

[d] Less than 0.5 percent.

Table 10
Trends in the Structure of Employee Benefits

Percentage of Employers with Cafeteria Plans Who Include the Following Types of Benefits in Program, 1987 and 1994

Types of Benefits	1987[a]	1994[b]
Spending Account-Health Care	85%	87%
Spending Account-Dependent Care	78	93
Health Plan Choices (Other Than HMOs)	94	71
Death Benefit Choices	46	39
Disability Benefit Choices	34	24
Time Off with Pay (buying/selling)	15	11
Profit Sharing or Savings Allocation (Other Than Separate 401(k) or Tax-Sheltered Annuity Plans)	13	6
Other (e.g., Financial Counseling) on a Post-Tax Basis	2	5

Source: Hewitt Associates, *Salaried Employee Benefits Provided by Major U.S. Employers,* 1988 and 1994 (Lincolnshire, Illinois: Hewitt Associates, 1988 and 1994).

[a] Survey summarizes principal benefit plans of 822 major U.S. employers.
[b] Survey summarizes principal benefit plans of 1,035 major U.S. employers

Mr. MICA. We thank you, and I will turn to Jeannine Strandjord, with the Financial Executives Institute. Welcome.

Ms. STRANDJORD. Thank you very much. Good afternoon. I would like to thank the chairman for the opportunity to testify on behalf of Financial Executives Institute before this subcommittee. I have also submitted prepared remarks, but, in the interest of time, please let me summarize them.

In general, most companies, as has been mentioned here today, create compensation and benefit programs with the goal of recruiting and retaining high caliber employees. However, this must be achieved within a reasonable budget in order to retain a company's competitiveness.

The trend in the private sector has been toward maximizing the benefit dollars available to the company. On average, the total cost of employee benefits is 18 percent of payroll, excluding such things as payroll taxes, vacations, and other paid time off—8.5 percent goes to health care; 6 percent to pensions; .6 percent to group life insurance.

The remainder is generally comprised of miscellaneous benefits, such as vacation time, accidental death, and/or long-term disability insurance, and in some cases, educational assistance or profit sharing.

However, since the economies of scale favor large companies, the level of benefits provided to employees varies between small, medium, and large employers. This variation in benefits is due to the simple fact that it is more difficult for smaller employers to build compensation packages which include the spectrum of benefits which larger companies are able to negotiate for their work forces.

In many cases, prohibitive costs prevent small employers from offering any benefits at all. Non-provision of benefits is also common in specific industries, such as many in the service industry, regardless of the size of the employer.

While benefit options vary widely among employers, it is possible to identify a number of distinct trends in the provision of these benefits. Most employers provide some health care benefits.

Among large employers, the current coverage rate is 99 percent, but, despite the company's size, the overwhelming trend has been away from traditional indemnity and fee-for-service delivery systems into managed care. Large companies have increasingly begun to self-insure, while smaller employees have, to the extent possible under current law, created purchasing alliances for health care.

Employers have been the driving force in the reform of the health care market by aggressively demanding cost-effective, quality care and developing best practice standards in order to evaluate the effectiveness of plan administrators.

As a result, last year, after years of increasing health care costs, the average cost of employer-sponsored health care plans decreased by 1.9 percent, although small companies increased, so there is still room for improvement here.

Another significant trend is the growing shift in the focus of health care from illness to wellness. By identifying health risks and adopting strategies to reduce, eliminate, or reverse these risks before they require treatment, employers can reduce their health care costs overall, while maintaining the employee's quality of care.

Approximately 85 percent of large employers, although still very few small companies, now offer wellness programs to their employees. Wellness programs are becoming increasingly popular for mid-sized companies, as they enhance the value of the benefit package at little or no additional cost.

The overwhelming trend in the private sector retirement income arena has been a significant migration to the use of defined contribution pension plans, especially among small and medium-sized employers. Among larger companies, defined benefit plans still constitute the vast majority of pension benefits, although many are now combining them with defined contribution plans, since these have been on the increase, also, with large employers.

Many small firms still do not provide any retirement income benefits, however, and it should be noted that with defined contribution plans, the contribution level is most often voluntary. Therefore, because of nonparticipation, especially among younger workers, there is a significant segment of the current work force without retirement income savings outside of Social Security.

Many companies have embraced the use of other benefits, including alternative work arrangements and dependent care, because they're often far less costly but are generally considered by employees to be valuable additions to the overall compensation package. Clearly, there has been a move toward greater flexibility in working arrangements, particularly with smaller businesses.

Finally, more companies are providing some form of dependent care. These follow a wide range of possibilities, but spending accounts are still the most common possibility with this type of benefit.

The design of employee benefits is influenced to a large extent by the demographics of the work force. Today, women comprise 50 percent of the work force, and many of these are mothers. Many employees, both male and female, are single parents, and some are caring for elderly parents.

Designing benefit plans which meet the needs of these employees, without discriminating for or against particular groups, has become increasingly challenging, giving rise to the growing use of flexible benefit plans or cafeteria plans, which have undergone a significant expansion in both scope and practice over the last decade, except with small employers who are still struggling to offer any benefits at all.

We have submitted an explanation of what is involved in most flexible benefit plans. Government policies, particularly the tax code, also influence the design and structure of benefits packages. Were the provision of tax benefits not tax deductible, you would see a substantial reduction not only in the level of benefits offered but, also, in the percentage of the work force covered.

Also, this impacts the manner in which specific employee benefit offerings are designed and operated, since most tax-favored benefits cannot be discriminatory.

In closing, I would also caution against the imposition of government mandated benefits, which are impediments to competition and force companies to either cut other benefits in order to reduce overall costs in some instances, could downsize their operations or, in some cases, might cause them to close down business altogether.

Small and mid-size companies are particularly vulnerable to the negative effects of mandated benefits, because their operating margins are much tighter and, as previously noted, the economies of scale favor large companies. In looking to reform the civil service, we urge the subcommittee to explore the range of cost-saving benefits now being offered in the private sector.

I thank the committee for the opportunity to testify today and would be glad to answer any questions at the appropriate time.

[The prepared statement of Ms. Strandjord follows:]

STATEMENT BY JEANNINE STRANDJORD

VICE CHAIR
COMMITTEE ON EMPLOYEE BENEFITS
FINANCIAL EXECUTIVES INSTITUTE

Good afternoon. I would like to thank the Chairman for the opportunity to testify on behalf of Financial Executives Institute (FEI) before the Subcommittee. My name is Jeannine Strandjord. I am the Vice Chair of FEI's Committee on Employee Benefits and am also the Senior Vice President and Treasurer of Sprint Corporation. FEI is a professional association of more than 14,000 senior financial executives of companies ranging from small businesses to major corporations throughout the United States and Canada. The Committee on Employee Benefits (CEB), one of FEI's eight technical committees, is the policy-making body for FEI on employee benefit issues. CEB is comprised of financial executives, from mid-sized to Fortune 50 companies, who are responsible for the development, implementation and management of pension, health, welfare and other pre- and post-retirement benefits.

CEB applauds the Subcommittee's willingness to explore private sector experiences in its deliberations on how best to reform the civil service. As financial executives, responsible for the corporate bottom line, we are in a unique position to advise on trends in the benefits arena with a view toward cost effectiveness.

From the outset I would like to note that, as a general rule, the larger the company, the better the benefits programs tend to be. Smaller companies offer less comprehensive benefits, with truly small employers almost universally not providing any benefits to their work force at all. Why? Simply because the economies of scale favor larger organizations. This is particularly true in the insurance arena, both for health and life coverage, because the risk pools are larger. That said, the general trend in employee benefits, no matter where an individual is employed, is toward not only cost containment but also greater flexibility, to accommodate an increasingly diverse work force.

What strategies are employers using to achieve these ends while remaining competitive in the marketplace and maintaining a quality work force? By way of background, it is useful to touch upon how companies formulate their compensation packages.

In general, most companies create compensation and benefits programs with the goal of recruiting and retaining high-calibre employees. However, this must be achieved within a reasonable budget in order to maintain a company's competitiveness. The ability to compete is crucial not only within a particular industry sector or geographic region, but also in the global marketplace. As world markets have expanded and more liberalized trade is embraced, U.S. employers have been put under increasing pressure to cut costs in all areas of operation. It is no longer possible for employers in the private sector to offer both high cash and high benefits compensation packages to their work force. The trend in the private sector, therefore, has been a movement toward maximizing the benefit dollars available to the company.

This has been achieved using a number of different benefit approaches, including the utilization of managed medical care, flexible benefits plans, and alternative work arrangements. Taken together, these strategies allow greater flexibility--for both employers and employees--while keeping costs at a minimum; thereby maintaining or enhancing the ability to compete in the world market.

The goal for employers is to ensure that the benefit dollars available are utilized to maximum advantage. Irrespective of a company's size, a significant proportion of its payroll is devoted to employee benefits. A recent study conducted by Coopers & Lybrand found that, on average, the total cost of employee benefits is eighteen percent of payroll. This excludes payroll taxes, vacations and other paid time off. Broken down, companies *spend an average of 8.5 percent of their payrolls on health care, 6 percent on pensions, and 0.6 percent on group life insurance. The remainder is generally comprised of miscellaneous benefits, such as vacation time, accidental death and/or long term disability insurance, and in some cases education assistance or profit sharing.*

However, since the economies of scale favor larger companies, the level of benefits provided to employees varies between small, medium and large employers.

	Company size (by number of employees):		
Percent of Payroll devoted to:	1-100	100-500	500+
Salaries:	74.1	71.3	68.8
Health insurance:	5.3	6.5	7.2
Pensions:	2.3	2.9	4.0
Group life insurance:	0.2	0.3	0.3
Miscellaneous:	18.1	19.0	19.7

In most instances, the large companies devote a greater percentage of their payrolls to the provision of benefits. Therefore, employees of large companies generally enjoy richer benefits packages. As one moves down the scale from the large employers to those with small work forces, it is almost universally true that the level of benefits offered is significantly reduced. The reason is simple: it is more difficult for smaller employers to build compensation packages which include the spectrum of benefits which larger companies are able to negotiate for their work force. In many cases, prohibitive costs prevent small employers from offering any benefits at all. Non-provision of benefits is also common in specific industry sectors (notably service industries), regardless of the size of the employer.

A wide range of benefits options is available to employers. Since many companies, and some industry sectors as a whole, tailor their benefits packages specifically for their work force or to compete in their industry sector, it is not always easy to compare one set of benefits to another.

However, it is possible to identify a number of distinct trends in the provision of health, retirement income and other benefits. Given their greater purchasing power and market share, large employers tend to set the standard with respect to employee benefits. With the exception of very small employers, those with fewer than 50 employees, the private sector in general has tended to follow the lead of the larger companies, though smaller companies may have to phase new programs in over a longer period of time. Perhaps the most dramatic changes have come in the arena of health insurance benefits.

With the exception of many small businesses, most employers provide some health care benefits. Where health benefits are provided, they comprise the largest portion of the compensation package after salaries. As you know, a significant proportion of the 37 million uninsured Americans are employed by small businesses or are self-employed. Among large employers the current coverage rate is 99 percent. Irrespective of the size of the employer-sponsored plan, the overwhelming trend in health care has been away from traditional indemnity and fee-for-service delivery systems into managed care.

Migration into managed care has been driven by spiralling health care costs. In 1994, 63 percent of employees with health care benefits were enrolled in managed care plans; up from 48 percent in 1992. Over the past few years, large companies have increasingly begun to self-insure; while smaller employers have, to the extent possible under current law, created purchasing alliances for health care. In both cases, this movement has led to greater use of managed care. More than half the employer-sponsored health plans offered today utilize either HMOs or Preferred Provider Organizations (PPOs). This has allowed employers of all sizes to contain costs while continuing to provide employees with access to quality care.

Employers have been the driving force in the reform of the health care market. We have been aggressive in demanding cost-effective, quality care and developing best practice standards in order to evaluate the effectiveness of plan administrators. We have demanded that programs provide demonstrated results in the areas of quality and cost management. The need to manage costs has led employers to take an increasingly proactive role in defining the health benefits programs and requiring our health plan administrators to manage those programs effectively. There has been some success as a result of these changes: last year, after years of increasing health care costs, the average cost of employer-sponsored health plans decreased by 1.9 percent. A caveat to this, however, is that small employers experienced an increase of 6.5 percent in health care costs in 1994.

Another significant trend in health care benefits is the growing shift in the focus of health care from illness to "wellness." Health promotion and disease prevention strategies are being integrated into their benefit plans. Participants in wellness programs are offered incentives to adopt healthier lifestyles (some plans use disincentives to discourage unhealthy lifestyles).

The underlying theory in the adoption of wellness programs is that an ounce of prevention is indeed worth a pound of cure. By identifying health risks and adopting strategies to reduce, eliminate or reverse these risks <u>before</u> they require treatment, employers can reduce their health care costs while maintaining the employees' quality of care. Common components of wellness include:

Health assessments and/or appraisals,
Prenatal and well baby care,
Fitness facilities or subsidized health club memberships, and
Employee assistance programs (EAPs).

Approximately 85 percent of large employers now offer wellness programs to their employees. To the best of my knowledge, it is exceptionally rare to *find wellness programs being offered by small employers. While the use of these programs is cost effective, no rationale exists for pursuing them in the absence of other health care coverage. Among medium-sized companies, wellness programs are becoming increasingly popular, as they enhance the value of the benefit package at little additional cost.*

The overwhelming trend in the private sector retirement income arena has been a significant migration to the use of defined contribution pension plans. This trend has been particularly prevalent among small and medium-sized employers. Having reached a peak in the mid-1980s the number of defined benefit plans being offered by small employers has declined steadily over the last decade. Conversely, small employer participation in defined contribution plans have seen a steady increase over the same period. Among larger companies, defined benefit plans still constitute the vast majority of pension benefits (approximately 70 percent). Defined benefit plans are increasingly offered in conjunction with defined contribution plans, which have steadily increased among large employers as well. Mid-sized companies fall in the middle, with a good deal of variation. To the extent that defined benefit plans are still offered by mid-sized companies, they are most commonly found among older companies.

Despite the rising use of defined contribution plans, it is important to bear in mind that many smaller firms do not provide any retirement income benefits. Although nearly 65 percent of large employers offer pension plans, that figure drops to approximately 45 percent among mid-sized companies. In contrast, only about 15 percent of small businesses offer pension plans to their employees.

A second cautionary note with respect to defined contribution plans is that the contribution level is often voluntary. Many employees are choosing not to participate in plans even when they are available. The majority of these appear to be younger employees and those in lower earnings categories. Therefore, there is a significant segment of the current work force without retirement income savings, outside of Social Security.

The other commonly found element of employee benefits programs is group life insurance. Plans under which both the employer and employee make contributions comprise the vast majority of the group life insurance plans (88 percent in the case of large employers). In general, employer-paid plans have less generous benefits than those with both employer and employee contributions. 48 percent of employer-paid and contributory plans offer benefits of up to five times salary, while 42 percent of employer-paid plans offer benefits of no more than one times salary. The level of employee contribution for employer-paid and contributory life insurance plans most often is determined by the participants' age.

Most larger employers also offer short- and long-term disability, as well as accidental death and dismemberment coverage. To the extent this coverage is offered by smaller employers, it is generally the case that the employer simply administers the plan and the employee is responsible for the contributions.

In addition to these traditional benefits, many companies have embraced the use of other benefits, including alternative work arrangements and dependent care. The advantage to these types of benefits is that they are often far less costly, but are generally considered by employees to be valuable additions to the overall compensation package.

In order to retain valued employees, and overcome potential productivity losses, an increasing number of companies now include alternative work arrangements within the benefits framework. Flexible working hours, *compressed work weeks, telecommuting, job sharing and allowing staff to work permanently on a part-time basis are becoming common components of corporate benefits programs. In 1992, CEB conducted a survey of FEI members during the Family and Medical Leave Act debate, and found that 63 percent of respondents offer their employees some form of flexible working hours. Additionally, 30 percent allowed employees to work a compressed week; 30 percent have employees who telecommute; 27 percent offered job sharing; and 86 percent had permanent part-time positions available.*

Clearly there has been a move in the private sector toward greater flexibility in working arrangements. Experience has demonstrated that not only have such policies improved productivity, they make employers more "competitive" with respect to recruiting and retaining high-quality employees. Policies such as these create a win/win situation because they are highly desirable to employees: and can be offered at little or no cost to the employer. Alternative work arrangements are particularly usefully employed by smaller businesses, as they allow smaller businesses to compete on a more equal footing with large corporations.

The last benefit I want to comment on is dependent care. Although employer-provided day-care facilities are rare in all but very large companies; many employers offer other forms of dependent care benefits. These can range from resource and referral services, to employer-arranged discounts with local child care providers, to dependent care spending accounts. Among these, spending accounts are by far the most common. Dependent care spending accounts allow parents to set aside pre-tax dollars to provide for their child care needs. CEB's survey found that 61 percent of companies offered dependent care spending accounts and that they were the most popular element in the benefits package those companies offered. Spending accounts and referral *services are highly cost effective: they provide the employee with a highly desirable benefit at very little cost to the employer. Use of these benefits is still limited among small businesses: however, given their cost effectiveness and desirability, it is likely that all but the smallest employers will continue to move in this direction.*

The design of employee benefits is influenced to a large extent by the demographics of the work force. One of the most significant demographic shifts we have seen over the last thirty years is the influx of professional women into the work force. When the typical employee was a married man whose wife stayed home to care for the children, a single benefits package could be created to suit the needs of nearly all employees. Today, women comprise fifty percent of the work force; and the majority of them are mothers. Many employees, both male and female, are single parents; some are also caring for elderly parents. Moreover, the work force in general is aging. Simply put: the benefits needs of the work force are no longer uniform. Designing benefit plans which meet the needs of employees, without discriminating for or against a particular group, has become increasingly challenging. This challenge has given rise to the growing use of flexible benefits, or "cafeteria" plans.

Flexible benefits have undergone a significant expansion in both scope and practice over the last decade Although flexible benefits plans were initially adopted as a means of offering tax-effective benefits, they have increasingly been used as a tool to enhance the overall value of benefits while managing benefit cost. Flexible benefit plans tend to be most commonly found among large employers. As of January 1994, approximately one third of Fortune 500 companies offered flexible benefits plans to their employees; and half of the Fortune 100s made these plans available. It is rare to find flexible benefits plans being offered by many small businesses since they often struggle to offer any benefits.

The most common components of flexible benefit plans include: health care coverage (99 percent of all plans); health benefits with the option of dental care (92 percent): group life insurance, including dependent life coverage (86 percent); long-term disability coverage (62 percent); spending accounts (96 percent); cash options (70 percent); vacation trading (26 percent); and 401(k) plans (19 percent). Individual components of flexible benefits plans and the number of options available vary widely from one company to the next. However, the following considerations generally drive the process in designing the content of flexible benefits plans:

How many options are appropriate?
What should those options look like?
Should employees be required to elect a minimum level of coverage?

Flexible benefits plans are most commonly found in the manufacturing sector, which accounts for slightly more than one third of the employers offering flexible benefits plans; and the financial services sectors, which provide a further ten percent of the plans. Flexible benefits plans are significantly less common in the retail and wholesale trades, and in most service industries. These plans allow employers to maximize benefit dollars and provide for a diverse range of employee needs. The value of specific benefits can also be highlighted to employees--who are now empowered to determine which benefits best address their particular needs.

As I noted at the outset, maintaining the ability to compete in a global marketplace is central to a company's design of its employee benefits package. In formulating their benefits policies, companies do the best to create an environment which will allow them to attract and retain a high-calibre work force. However, I should note that government policies, particularly the tax *code, also influence the design and structure of benefits packages.*

Many employer provided benefits are not considered income for purposes of federal and state taxation. The tax consequences to employees and employers of benefits is a significant factor in the design of employee benefit packages. For example, contributions to qualified employee retirement plans are currently tax deductible to the employer, however, such contributions are not taxable to the employee until they are withdrawn or distributed from the plan. This favorable tax treatment makes such plans appealing both to employers and employees.

Similarly, the tax deductibility of health insurance premiums is very important in allowing companies to offer high quality health care coverage to their employees. For many smaller and mid-sized firms, the ability to offer comprehensive health care coverage is one of the essential elements in competitive benefits programs. Were the provision of health benefits not tax deductible, you would see a substantial reduction not only in the level of benefit offered but also in the percentage of the work force covered.

The tax law has a significant impact on more than simply which benefits are offered in a benefits package. It also impacts the manner in which specific employee benefit offerings are designed and operated. For instance, most tax favored benefits can not be discriminatory. The tax law provides specific tests in many cases which must be met in order to demonstrate that the benefits is nondiscriminatory. The tax law also provides limits on contributions which can be made to qualified retirement plans and benefits which can be received from such plans. Retirement plans must be designed to stay within these limits so that contributions and earnings in the plan will continue to be tax deferred for participants.

In many cases tax policy impacts not only the design of benefits *packages but also whether certain benefits are provided at all. Because tax law has allowed employees to receive tax-free reimbursement of educational expense, many employers had established programs to pay for employee education. This law expired at the end of 1994. As a result, many employers are now reevaluating whether it makes sense to continue providing this benefit. I understand the favorable tax status would be extended by the recently passed reconciliation package.*

Tax law is an important factor to consider when designing employee benefit packages. In general, because of the complexity and expense of sponsoring qualified retirement plans and other tax advantaged benefit offerings, large employers are more likely than small employers to offer them as part of an employee's compensation package.

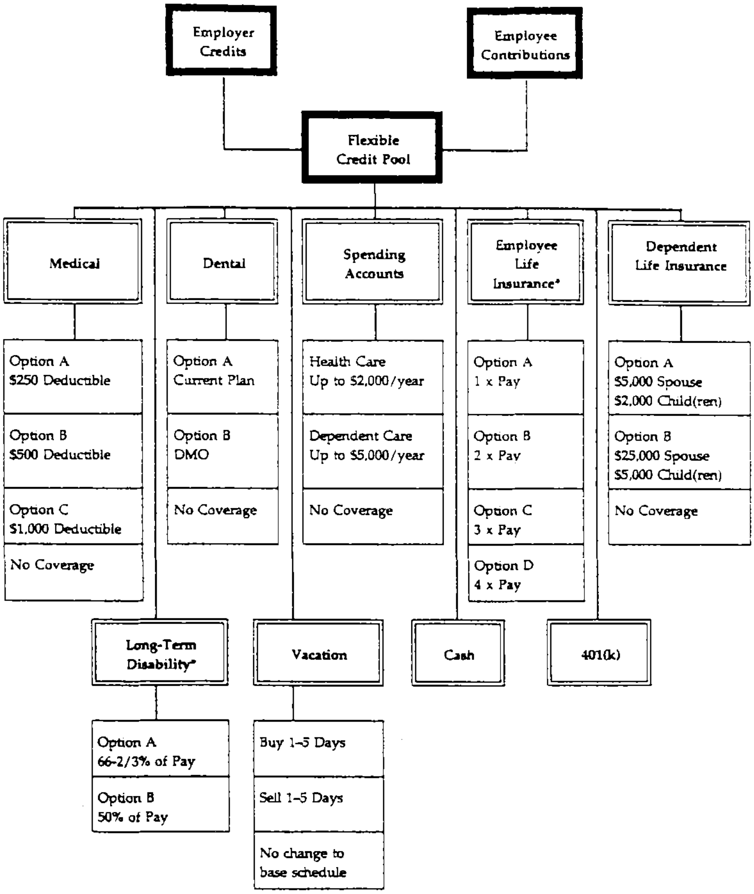
In closing, I would caution against the imposition of government mandated benefits. Mandating benefits fails to take into account what effect the provision of those benefits will have on a company's cost of doing business. Moreover, they do not recognize that some benefits have greater relative importance in some industry sectors than in others. Any company which wishes to recruit and retain high-calibre employees will, to the maximum extent practicable, offer a benefits package which is best suited to the needs of those employees. Mandated benefits impair the ability to compete in a global market place. Such impediments to competition force companies to: cut other benefits in order to reduce overall costs; down-size their operations; or, in some cases, to close down the business altogether. Small and mid-sized companies are particularly vulnerable to the negative effects of mandated benefits, because their operating margins are much tighter and, as previously noted, the economies of scale favor large companies. Mandating benefits will not serve the long-term needs of the American work force.

The realities of global competition mean that we must all make choices and set priorities. Our ability to attract and retain a high-quality work force is paramount to our survival in the world market place. This has been achieved through aggressive cost containment and innovative new strategies to ensure that available benefit dollars are maximized. In looking to reform the civil service, I urge the Subcommittee to explore the range of cost-saving benefits now being offered in the private sector.

That concludes my prepared remarks. I thank the Committee for the opportunity to testify and would be glad to answer any questions.

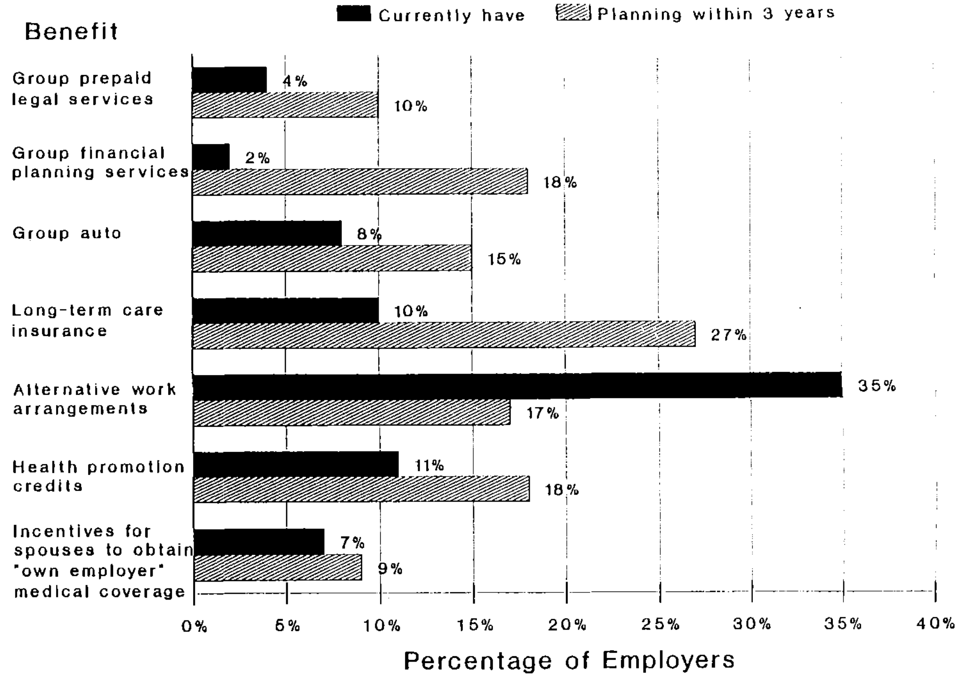
Flexible Program Design Example

The following diagram illustrates an example of benefit options under a flexible benefit program.



*No opt-out provision; employee must select coverage.

Areas of Benefit Flexibility



Hewitt Associates

Mr. MICA. Thank you. I think we've got about 10 minutes to vote. I would rather not rush you, Mr. Kelly.

Mr. KELLY. Thank you.

Mr. MICA. Why don't we recess until about 25 after? I should be back between 25 after and 2:30. We'll recess until that point.

Mr. KELLY. Very good.

[Recess.]

Mr. MICA. I would like to call the subcommittee back to order and now recognize Mr. Peter Kelly, with the U.S. Chamber of Commerce. If you would like to summarize, we would appreciate it.

Mr. KELLY. Yes.

Mr. MICA. Thank you.

Mr. KELLY. Thank you, Mr. Chairman. I'm aware that there are no unimportant votes that you are involved in nowadays and appreciate the need for the recess.

My name is Peter Kelly. I'm an attorney in Chicago with the law firm of Murphy, Smith & Polk, and I serve as chairman of the U.S. Chamber of Commerce's Qualified Plans Subcommittee and as a member of its Health and Employee Benefits Committee.

The Chamber has approximately a quarter million business members, 3,000 State and local Chambers of Commerce, 1,200 trade and professional association members, and 73 American Chambers of Commerce abroad. Approximately 96 percent of the Chamber's members are businesses employing less than 100 employees.

I will not read my statement or the attachment, but will request that they be submitted for the record.

Mr. MICA. Without objection, so ordered.

Mr. KELLY. We appreciate the opportunity to appear before the committee to present the information that has been requested. In that spirit and by agreement with the other members of the panel, I am going to turn to the issue of numbers and statistics.

I am basically going to give you an advance look at the Chamber's 1995 benefits survey. This is a survey that's sent out to Chamber members every year since—well, every year since 1986, I believe, and before that, every other year since 1929. That survey measures employee benefit expenditures compared to the cash wages. We measure it a little differently from some of the statistics you heard a few minutes ago, in that we take 100 percent of direct payroll as our basis for measurement of indirect payroll.

Working off of that number, if we look over the past 20 years, employers have consistently expended an amount in each of those years on employee benefits which is in excess of one-third of their direct payroll costs. In 1994, employee benefit payments represented an amount equal to 40.7 percent of direct payroll costs. One of the charts attached to the more lengthy piece will show graphically how this has increased over the years since 1955, when it was below 20 percent, to the present 40.7 percent figure.

Focusing on particular plans and the purposes they serve, if we think of major medical, that's primarily to protect employees from the financial risks they may incur as a result of expenses for sickness or injury.

Conventional medical and health plans, financed at least in part by employers, are maintained by 98 percent of the employers responding to the survey in 1994; 25 percent of the employers contributed to health and medical plans for retirees. The other categories that we studied, dental and vision care, in 1994, 46 percent and 38 percent maintained such plans, at least partially at employer cost.

During 1994, employers expended an amount equal to 9.7 percent of their direct payroll in providing medical and health care. That disregards sick pay and short term disability that are sometimes counted as medical expenses. That's slightly down from 1993, primarily due to the fact that employees are bearing a slightly higher proportion of the expense, not because there has been a decrease in medical expense costs.

The next most frequent employee benefit feature is life insurance to protect employees and dependents from the risk that the employee may die without leaving sufficient resources. In that sense, life insurance is actually death insurance.

During 1994, 87 percent of all employers responding to the survey maintained life insurance at employer cost, but the burden of maintaining that life insurance was relatively slight, in that employers only expended about .4 percent of payroll for providing that protection.

Now, that slightly underreports the expense, because, since ERISA was passed, employers are mandated to provide some death benefit protection through their pension plans—defined benefit pension plans, and that isn't reported in that figure.

The next most frequent type of plan is disability plans, protecting employees and employees' dependents from the risk that the employee may be so severely sick or hurt as to be unable to work for either a short or a long period of time. Short-term disability of this type is reported under two categories in the survey, either as sick pay, which you would ordinarily think of as the pay for relatively short periods of time while ill, and formal short-term disability plans.

The other category of disability, of course, is long-term disability. During 1994, 57 percent of employers reported that they were providing long-term disability coverage. Thirty-seven percent reported that they were providing short-term disability coverage under a formal STD or short-term disability policy, and 71 percent reported that they were providing disability protection in the form of sick pay.

The cost of those programs for all three of those categories of disability coverage in 1994 was 1.9 percent of payroll.

In 1994, 56 percent of employers contributed to section 401(k) salary reduction plans; 36 percent reported that they were contributing to defined benefit pension plans; 27 percent reported that they were contributing to profit-sharing plans; and 7 percent reported that they were contributing to employee stock ownership plans.

During 1994, employers expended 7.2 percent of their direct payroll in providing retirement benefits. That's slightly up from 1993. Severance pay has been studied separately in this survey only recently, within the last few years, and it basically is less than 1 percent of pay at this point.

Focusing for a moment on the primary objective of this committee, which is to study the private system in order to find parallels or possible learning to apply in the Federal system, I will offer a couple of observations, and then I'll stop talking. One thing that has marked the private system, that may be good to keep in mind in looking at the public system, is a great deal of flexibility.

It's an employment-based system, and there are variations, significant variations that reflect the particular needs of the employment setting. Even in the public sector, there can be significant differences in different tasks or different assignments.

In addition to that, we would certainly advise that whatever is done in the public sector, keep in mind, on the retirement side, that pre-funding is probably the most important criteria for sound retirement planning.

With that, thanks for the opportunity to appear, and I think the entire panel is available for questions.

[The prepared statement of Mr. Kelly follows:]

STATEMENT
on
PRIVATE EMPLOYEE BENEFIT PRACTICES
before the
SUBCOMMITTEE ON CIVIL SERVICE
of the
HOUSE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

by
Peter M. Kelly
October 31, 1995

Mr. Chairman, my name is Peter M. Kelly. I am an attorney in the Chicago law firm of Murphy, Smith & Polk and also serve as chairman of the U.S. Chamber of Commerce Qualified Plan Subcommittee and as a member of its Health and Employee Benefits Committee. I appear before you on behalf of the U.S. Chamber of Commerce Federation of 215,000 businesses, 3,000 state and local chambers of commerce, 1,200 trade and professional associations, and 73 American Chambers of Commerce abroad. We appreciate the opportunity to appear before this subcommittee to present the information requested concerning employee benefit practices of private employers.

I am accompanied by David Kemps, the U.S. Chamber's Manager of Employee Benefits Policy in its domestic policy division. Mr Kemps has a legal background in employee benefits having practiced law at the PBGC for four and a half years.

In order to fully respond to the Subcommittee's questions without imposing unduly upon the schedules of Subcommittee members and staff, we have attached a detailed description of the employee benefits practices of private employers, including statistics from the Chamber's most recent survey of employee benefits practices. I will devote these remarks to a brief summary of the attachments and a discussion of certain employee benefit trends of which this subcommittee should be aware as it considers the enclosures.

1. **Retirement Plan Trends.** As we look ahead to future developments affecting retirement plans, it is important to note that after 20 years of intense pressure for a shift to a mandatory system, we still have a voluntary private retirement system which offers far-sighted employers important tools for attracting and retaining a world class workforce. Economists predict that the future growth and profitability of our nation will depend upon service sector businesses. In a very real sense, skilled workers are the tools of the trade upon which much of our nation's future depends. Their continued contribution to business growth and profitability will depend upon continued satisfaction of their personal needs for retirement security.

a. **Defined Benefit Pension Plans.** No retirement plans are more important to the future of American business than are defined benefit pension plans. Since enactment of the Employee Retirement Income Security Act of 1974 (ERISA), the rate of growth of defined benefit plans has decreased. During the past six years, there has been a negative net growth of such plans. Sponsors of defined benefit pension plans have been subjected to increased funding burdens and they have been required to pay increasingly burdensome annual per capita termination insurance premiums. In addition, during the past 15 years employers have seen a significant diminishment of their right to recover excess assets in the event that an overfunded defined benefit pension plan terminated.

The diminished reliance on defined benefit plans to provide retirement benefits has not been uniform throughout the economy. Larger employers continue to rely on defined benefit plans as the most inexpensive method for providing retirement security to a large workforce.

The defined benefit plan termination insurance system remains at risk because of the failures (or the projections of future failures) of insured defined benefit plans in certain troubled industries. This concern has been alleviated somewhat by the success of Pension Benefit Guaranty Corporation (PBGC) legislative initiatives. Although it is widely perceived that defined benefit plan problems stem from weak industries, those industries have always been with us and do not fully explain the financial problems of the PBGC. A more fundamental problem is the trend away from defined benefit plans. This trend has drastically shrunk the termination insurance premium base.

Despite employers' concerns about the cost burdens and potential liabilities of maintaining a defined benefit plan, the aging of the baby boom generation will likely force many employers to reconsider such plans. Over the next decade these new pressures for adequate retirement benefits will force many employers to establish such plans.

b. **401(k) Plans**. ERISA placed an embargo on the formation of new salary reduction and cash and deferred plans (now known as 401(k)) plans. That embargo was lifted 16 years ago. Since that time, there has been an explosive

In relying on 401(k) plans (instead of or as a supplement to defined benefit plans), employers have utilized a program that relies on employee savings. These programs have been successful because, to a great extent, employees have been willing to save toward their retirement through and attractive tax-favored investment vehicle. However, many employees fail to save, and many other employees have drawn down their retirement savings prior to retirement because of job changes or other significant changes in their employment relationship.

Public policymakers have begun to critically examine the current reliance on 401(k) plans and have tentatively concluded that such a reliance - as the primary retirement vehicle for employees - is undesirable. If this insight is shared by enough policymakers, it is likely that ERISA and other laws and regulations applicable to the operation of 401(k) plans will undergo changes to discourage reliance on these plans. However, 401(k) plans have been so successful that it is unlikely that such a policy shift will significantly reduce the number of these plans, or their importance, in the foreseeable future. As with defined benefits plans, small employers face similar statutory and regulatory obstacles to plan formation and sponsorship. Unless small employers are provided with incentives to sponsor such plans for their employees, coverage will continue at abysmally low levels among small businesses.

c. **Employee Stock Ownership Plans.** There has also been some growth in employee stock ownership plans (ESOPs). These plans tie future retirement security to the health and well-being of the plan sponsor. ESOPs often play an important role in the financing of changes in corporate ownership between different groups of investors or between different generations of the same family.

There are many ESOP success stories. There are also disastrous ESOPs or ESOP disasters in the making. Because such programs offer a unique method for changing business ownership and diffusing ownership among an employee group, there appears to be no question that ESOPs are here to stay. However, celebrated cases of ESOP losses will fuel pressure for reforms. Depending on the strength of the public outcry, those reforms could be excessive and threaten the use of ESOPs as a viable business financing technique.

d. Retirement Plan Investment Trends. Throughout the post ERISA enactment period, retirement plans have been the most important single source of investment capital in our financial markets. This role is not likely to change anytime soon. The increasing awareness of the importance of retirement plans has been accompanied by an alarming rise in reports of investment losses stemming from careless, fraudulent, or criminal conduct. This has been particularly noteworthy during periods of economic hardship. The large size of many retirement plans and the complexity of the investment techniques used by those plans has contributed to the risk of such losses. There will likely be a trend toward higher standards of fiduciary behavior and more safeguards to prevent such losses. This will be marked by increased reporting obligations and greater financial controls. Hopefully, federal regulators will not lose sight of the limited resources available to small employers when crafting reporting requirements for plan fiduciaries. Such requirements may only act to deter, even further, small employer participation in plan sponsorship.

e. **Increased Complexity of Plan Provisions and Emphasis on Administrative Enforcement.** Over the past 20 years, retirement plans have been subjected to almost annual legislation and even more frequent regulatory changes. These changes have imposed more and more compliance burdens and contributed to an undesirable complexity of plan design. The primary thrust of such changes has been an effort to restrict the benefits of highly compensated employees in order to encourage the delivery of more significant benefits to rank and file employees. As the benefits of highly compensated employees have been cut back, many employers have responded by offering highly compensated employees replacement benefits on a non-qualified basis.

As a result of these changes, the administrative costs and the burdens of maintaining retirement plans have dramatically increased. There is a serious question as to whether the legislative and regulatory churning has achieved anything beneficial. It has clearly had the effect of discouraging plan formation and overburdening plan sponsors. This is especially true with small employers. Becuase the administrative costs associated with plan sponsorship are so high, large sections of the small business community have been effectively eliminated from retirement plans for their employees. We are hopeful that at least some reform is enacted during this Congress.

At the same time, the Internal Revenue Service and other regulatory agencies have shifted their focus from an emphasis on voluntary compliance to an audit based focus on deterrence. Although there has been a considerable backlash against this shift, the future is likely to involve greater risks arising from plan administration than were present during the early years following enactment of ERISA.

f. Growth in Litigation. There has also been a growing trend toward litigation concerning employee benefits. In part this is a reflection of the maturing of the retirement system and the completion of the ERISA statutory and regulatory scheme over the past 20 years. This also reflects increased access to courts and increased availability of attorney fee awards. It is likely that this trend will accelerate with future enforcement litigation.

2. Health and Other Welfare Plans. Since enactment of ERISA, government officials have emphasized retirement plan rules. The future will be marked by greater changes in law and regulations affecting employer sponsorship of health and other welfare benefit plans.

a. Health Reform. The next few years will almost certainly see enactment of health reform legislation. These changes, along with the pending changes in Medicare and in employer and health provider behaviors brought about because of legislative initiatives, will help reshape the provision of health care.

Large employers will likely experience fewer changes in their health plans than will any other categories of employers. However, all employers will experience significant changes. Benefits and plan provisions will become more standardized as will claims procedures and claim forms. Employers will continue to rely on managed care features but will experience little savings compared to current costs. If health reform produces significant savings, it will only be by a leveling-off of the rate of growth in costs, and not by an overall reduction in costs. The most significant changes in health care will come in provider/insurer realignments which are already underway.

The beneficial impact of health reform will be dramatically influenced by local factors. In those companies where employer and provider groups become deeply involved in reform, tremendous benefits should be produced.

b. **Flexible Compensation.** Cafeteria plans and other flexible compensation concepts do not fit well in the context of a reformed health system. There is considerable question whether they will remain viable in this context. However, flexible compensation is a concept that is well established and it should survive in the context of other employer-sponsored welfare benefits.

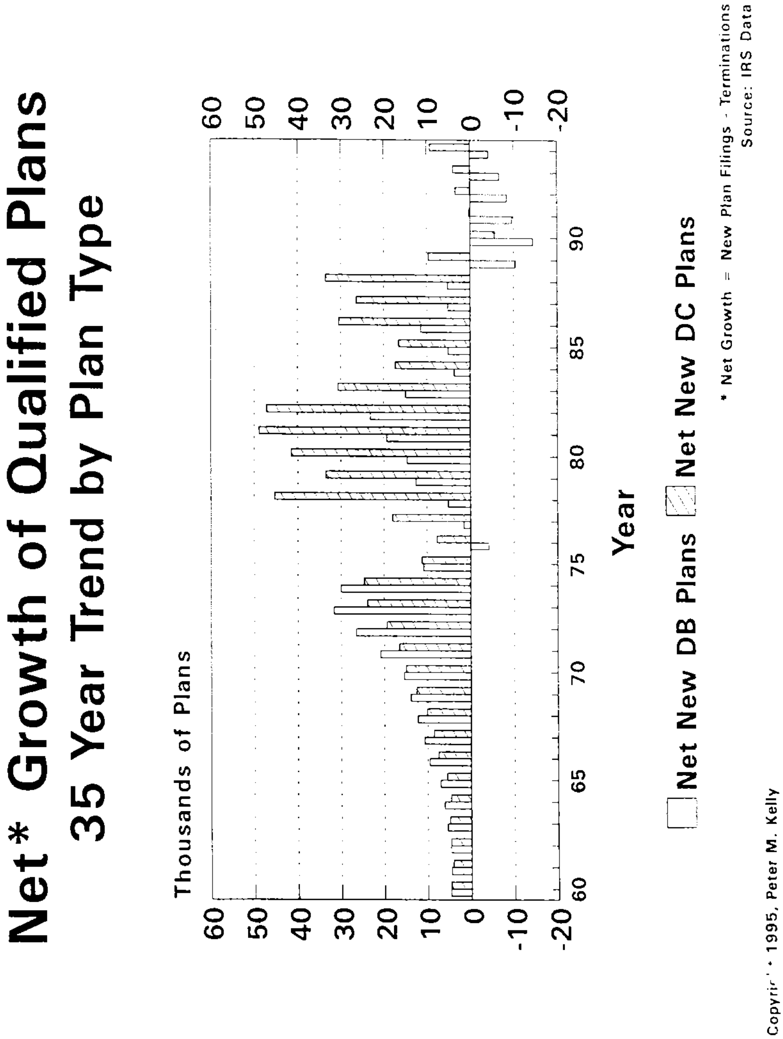
c. **Continued Innovation in Welfare Benefits.** The emphasis on service workers will produce continued competition for skilled workers. Employers will continue to develop new welfare plan and other employee benefit/fringe benefit innovations designed to attract and retain skilled workers. Some of the growth areas may well be in the long-term care and training of employees so they will be better able to meet the new demands of our service economy.

3. **Interdependence of Retirement and Welfare Plans.** Employers have finite resources which must be spread among an array of employee benefit plans and

programs. In fact, the growth of health plan expenditures has had a depressing impact on the resources available for retirement benefits. The interdependence of plans is reflected in this and many other ways. The payroll and other data collected for one plan typically are essential for the administration of other plans. There is considerable overlap in the skilled personnel used to manage retirement and welfare benefit plans. This interdependence is likely to grow, representing a practical reality with which employers must contend and which policymakers should accept.

Conclusion

The above represents a brief overview of the benefits programs that private sector employers currently offer their employees, with discussion of the trends that are occurring, and will continue to occur, in these plan areas. I would be glad to answer any questions that the members of this subcommittee may have on my remarks.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Net New DC Plans
* Net Growth = New Plan Filings - Terminations
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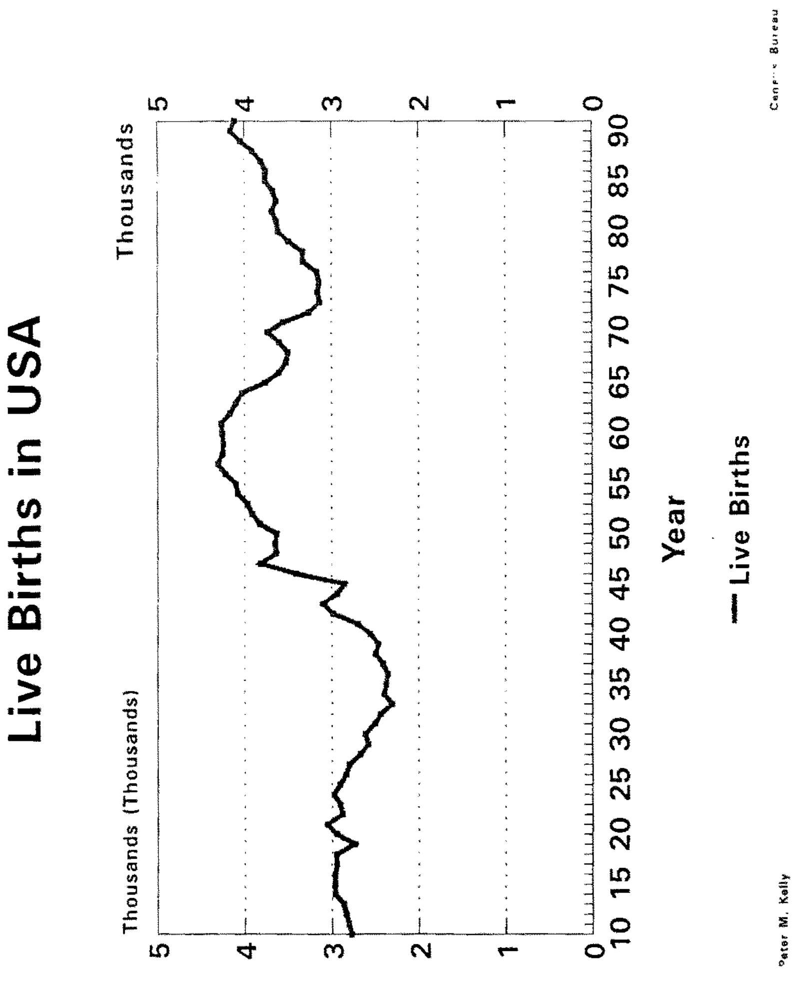
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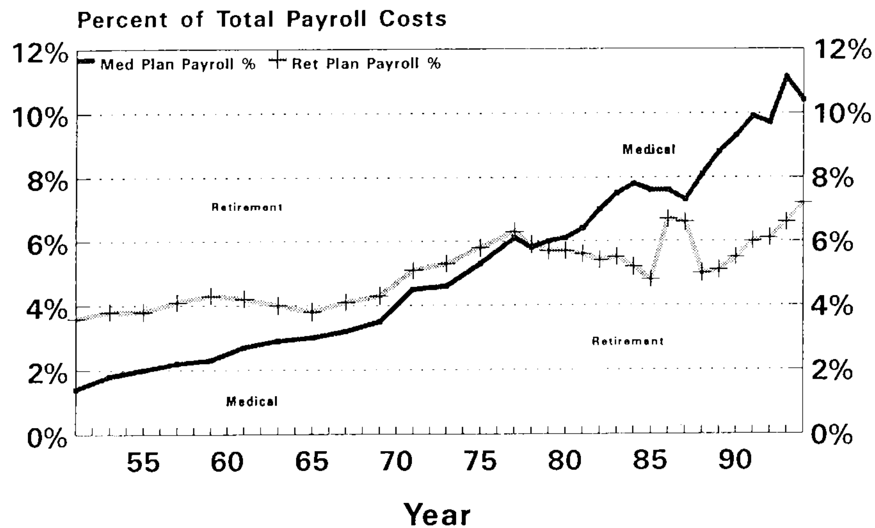
Employer Health Plan Displacement of Retirement Plans: A 43 Yr Trend



Before 1986 medical costs included life insurance and excluded vision care
US Chamber Surveys of Employee Benefits

Mr. MICA. Thank you for your testimony, each of our witnesses today. I have a couple of questions for Mr. Salisbury. You mentioned in your testimony that some of the State and local government compensation trends are differing from the Federal Government. Could you elaborate on that?

Mr. SALISBURY. One relates to the area of flexible spending accounts. The Federal Government has not made available child care or health care flexible spending accounts to its workers, whereas State and local governments have very commonly made them available to their workers for flexibility in paying for child care and health care.

A second change, which is—and that's a fairly broad-based area, flexibility in State and local government. The second area is in terms of retirement plan creation. If we look simply at the District of Columbia government, individuals going to work for the District of Columbia government in the regular D.C. civil service, for the better part of the last decade have no defined benefit pension plan. They exclusively have a 7 percent employer contribution defined contribution plan, plus Social Security.

So individuals, for lack of a better example, in the last 10 years, going to work for the District of Columbia, relative to workers going to work for the Federal Government of the United States, have total compensation packages that are, in essence, for an equally graded individual, worth about 40 percent less as a proportion of cash compensation for a District employee, as compared to a Federal Government employee.

If one looks at other States, we have a change in the freezing of the defined benefit pension plan in the State of West Virginia and a movement toward defined contribution, a movement toward cash balance defined benefit, the so-called hybrid approach in the State of Colorado, and studies in a number of other States, looking at these issues for adjustment in the packages.

They did not make the statement in the testimony and don't make the statements here as necessarily saying what they're doing is necessarily good. I'm simply underling that these types of evaluations and changes are not just taking place in the private sector.

Mr. MICA. I think you also stated that the trend is moving away from cost-of-living adjustments.

Mr. SALISBURY. Automatic cost-of-living adjustments in a pension form, like are available for Social Security and Federal and military workers, at the time we were working with this committee and others in the early 1980's, one of the bases on which COLA's had originally come into the Federal employee programs was because Federal employees were not covered by Social Security, and if they did not have Social Security, they would get no cost-of-living adjustments.

In the public sector, there was some of that similarity, yet, over the last several, if you will, decades, as public employees have been brought into the Social Security system, so they get that portion of their income indexed, there have not been offsetting adjustments, in many cases, to reduce indexation in their basic pension plan.

I compare that and contrast that to the private sector, in which the principal basis for post-retirement benefit increases is, in fact, what they get from Social Security. The handful of private sector plans, plans like the defined benefit plan that used to exist, for example, at Equitable Life Insurance Society, was at one time automatically indexed for inflation up to 3 percent. That plan, for new hires of the last 10 years, no longer exists, and the amount of indexation has been decreased.

In terms of broader surveys, there has been data over the years that about half of private sector plans did indexation equivalent to about half of cost-of-living increases over time, and those numbers have decreased, as well. It now appears that only about one-third of private defined benefit plans are doing any post-retirement indexation, and that is being reduced, as well.

In the private sector, the more general trend now is to say, if you have a defined benefit plan, it will be, if you will, a frozen benefit. You will have a 401(k) plan opportunity to aggressively save and to create an account that essentially will allow you to adjust for inflation post-retirement.

Mr. MICA. Well, one of the things that we have to contend with in government that the private sector doesn't is that the employee groups not only work for you, but they also vote for Members of Congress, and that sort of messes up the equation. Any time you talk about changing compensation, they all go crazy, and threaten retribution at the polls, et cetera.

In the private sector, how do they deal with the employee groups? I guess you don't have the equation of being voted out of office. To make any changes here, we have that equation, which I want you to keep in mind.

Mr. SALISBURY. I understand.

Mr. MICA. And then we must deal with employee groups. What do you recommend as an approach?

Mr. SALISBURY. I think the approach that private sector entities that you are concerned about "voting plus productivity," they are concerned about continuing productivity. In most private sector entities, when they make these adjustments, they make these adjustments over relatively long periods of time.

For example, take retiree medical benefits. An employer might well say those who are over the age of 55 will have no change in their benefit. Those who are between 45 and 55 will move on to a vesting schedule for retiree medical benefits, so that, instead of getting a full benefit, if you happen to be here at retirement age, you will accrue a benefit at a rate of, say, 3 percent a year, and only if you have been here for a full career will you get a full retiree medical benefit.

And then to say, as many companies have, if you are under the age of 40, you should expect no retiree medical benefit whatsoever. In terms of defined benefit plans, the adjustment when a company—and I attempted to underline, very few large employers in the private sector have eliminated defined benefit pension plans. The media has written as if they have. In general, it is false.

What private sector companies that have had traditional and still have traditional defined benefit pension plans have done is they have supplemented them, as did the Federal Government in 1984 with defined contribution programs. Then they have ceased to make the defined benefit plan more generous prospectively, whereas, in a prior point in history, they would have gone ahead making it more generous over time.

So we're seeing adjustments, but some of what I have seen—the last time, the Washington Post put this on the front page. The headline was essentially a headline that implied that the private sector, en masse, was eliminating defined benefit pension plans, and that is absolutely false.

Mr. MICA. Just one question and then I want to give my other colleagues here an opportunity. You state there has been a movement in recent years toward a growing component of at-risk or incentive compensation. What are some examples of at-risk or incentive compensation?

Mr. SALISBURY. What I'll refer you to, Mr. Chairman, is the excellent testimony that has been submitted to you by Hay Associates that has multiple charts in this area. This is gain-sharing; this is one-time bonuses; this is team bonuses; this is extensive use of so-called profit sharing, and there are percentages of the availability and contemplation of those programs in the testimony from Hay.

Mr. MICA. We'll get to them in the second panel. I don't want to take any more time for questions at this point. I'll yield to our ranking member, Mr. Moran.

Mr. MORAN. Thank you, Mr. Chairman, but since my colleague, Mr. Holden was here before me, would you care if he went first?

Mr. MICA. I would be glad to yield to Mr. Holden. Go right ahead.

Mr. HOLDEN. Thank you, Mr. Chairman. Mr. Chairman, I often hear the Federal Employee Health Benefit Plan referred to as the model program. I have to tell you that, in my prior life, I was a county sheriff, and I wish I had those health benefits back again, when I compare that to what I have right now.

Mr. Salisbury, I believe, in your testimony, you stated that Federal employees' health benefits, the program is similar to large corporations right now; is that correct?

Mr. SALISBURY. Relative to large corporations—that would be accurate, sir.

Mr. HOLDEN. I know, in my district, we have a huge AT&T presence and Carpenter Technology, and the Dana Corp., and I do know that their benefit packages are extraordinary. They're better than the Federal employees who work in my district right now. But, in general, you believe they're about the same?

Mr. SALISBURY. Of very large corporations and viewing the Federal Government as a very large employer, there is significant comparability, yes.

Mr. HOLDEN. And the CRS recently issued a report stating that the Federal retirement is no better than the private sector retirement plans. Do you agree with that?

Mr. SALISBURY. I do not, no. We've looked at that study and other analyses and cannot find a basis for that judgment.

Mr. HOLDEN. Any specific areas where you can identify differences?

Mr. SALISBURY. Principally the issue of post-retirement indexation, which roughly triples the value of the defined benefit pension plan and the cost of a pension plan. So, if you assume very low rates of inflation, you don't get a significant kick out of it.

But if you look at periods such as the 1970's and very high inflation, one way you can cut the numbers, which is to use the civil service assumption, which is the assumption that you would never have a point in history where inflation would exceed 5 percent.

If you make that assumption, then it holds down the expected cost of the plan, but if you used dynamic assumptions and, for example, the long-term inflation assumptions of the Social Security trustees, then you would get higher cost variation in the plan. But the principal differential is not in the basic benefit formula, it is in the long-term cost of post-retirement indexation.

I will add, Congressman, that I would love nothing more than to have a nice defined benefit plan with post-retirement indexation, myself. [Laughter.]

Mr. HOLDEN. I believe just about every member of the panel talked about flexibility. In general, have employees been receptive to flexible benefit plans and so-called cafeteria-style plans?

Mr. SALISBURY. I think the surveys clearly indicate a preference for choice. We've done several years' worth of surveys through the Gallup organization, and that is a consistent finding.

Mr. HOLDEN. For those companies that use these types of plans, do you find their compensation costs to be significantly different from those companies that do not?

Mr. SALISBURY. In the larger enterprises, no; in some of the smaller enterprises, yes. And that's principally because, in the larger enterprises that use the full cafeteria plan, they are really not generally using it overall as a cost control mechanism. They really are using it as a choice mechanism. As I said, that is a relatively small population. It's 13 percent of private sector workers.

Mr. HOLDEN. This might be a premature question, but we all know that there's going to be changes to the Medicare and Medicaid system. Have you done any research to try to factor in the cost-shifting that will absolutely have to occur because of the cutbacks in the Medicare and Medicaid programs and how that would affect the private sector's insurance premiums?

Mr. SALISBURY. We've looked at it over time, and the extant research would clearly indicate that, in the absence of significant reductions in the profit margins of managed care organizations—meaning the cost shift would be to the shareholders of those entities, rather than to premium payers—in the absence of that type of squeezing of profit margins, then you would have an inevitable amount of cost shifting to hospitals, doctors, and to other payers, meaning to the private sector.

In the historical studies, you show that as potentially adding 1 to 1½ percent to private sector medical inflation, but that, as I say, is old studies. Those are not studies looking at the new proposals.

Mr. HOLDEN. Adding 1 or 1½ percent in addition? Thank you.

Mr. MICA. I thank the gentleman and recognize Mr. Moran.

Mr. MORAN. I don't think I need to ask questions of the panel. Most of it is in their testimony. Thank you.

Mr. MICA. Before we conclude, I had asked a couple of questions during my questioning time, and I wondered if Ms. Strandjord wanted to respond, or Mr Kelly, before we dismiss the panel.

Of the questions that I posed, one was related to the differences between the public sector and private sector, and some of the constraints we face in making these changes. If you wanted to respond, you're welcome.

Ms. STRANDJORD. I would very much agree with Mr. Salisbury's comments on that, that those are usually done over time. I also believe that some companies use going to a flexible benefits plan or a cafeteria plan as an opportunity to make some changes in their benefits. So I think I would very much agree, though, with Dallas' point of view on this.

I would point out one other thing. Especially, I believe, with large companies, as they go to more and more of the salary structure really being based on some kind of a bonus based on the company's profitability, it makes the employee really part of the whole plan, as opposed to looking at it as a take-away, strictly a take-away.

Mr. MICA. Thank you. Mr. Kelly.

Mr. KELLY. Yes. I would just like to add a comment on COLA's. I also am in agreement with the observations that were made by Dallas Salisbury. However, I was very much struck by your description, Mr. Chairman, of the dilemma that's faced with COLA's, where the voters are involved.

It reminded me of the Medicare problem and the Social Security problem, where similar concepts are at work. In trying to make the shift over to private employment, the question arises why is it that COLA's are not as big a problem in the private employment?

I guess it's because COLA's are almost a Faustian deal. It's a problem that, once you've made the deal you can't unmake it. Once the culture of COLA's has settled in, you're stuck with it, and you're damned if you do and you're damned if you don't.

I think employers increasingly, over the years, have approached it from the point of view of their fiduciary duty to shareholders—who often are institutions, themselves, pension funds and others—their fiduciary duties to shareholders to manage the financial affairs of the enterprise in a way where the promises that are made in a time and under circumstances where they know or they have a reasonable plan for how they're going to pay for those promises.

When you begin making COLA promises, substituting an automatic formula, you can have some fairly dramatic adverse consequences that flow from it that may have no relationship to how well the enterprise is doing when the COLA comes due.

In fact, you can get caught in some very serious countercyclic forces, where a COLA kicks in just when the business is down, and you've essentially turned over the keys to the treasury and the net worth of the company if you do it, almost like the proverbial drunken sailor, so that I think that the typical private employer, the manager of a private company, would say, "Just say no, and don't start it."

Mr. MICA. Well, you know, over the past two or three decades, we've gotten ourselves hooked on this. You have only to take a second look at the Federal budget, and look at what we were spending money on 20 or 30 years ago, and what we're spending it on today, then factor in the COLA's, when you've got two-thirds of the budget on automatic pilot, and then your two biggest programs with 10 to 13 percent increases on top of that.

Mr. KELLY. It's almost like a drug.

Mr. MICA. You can see how we get in this fix. Well, I thank you very much for the perspective you bring to our hearing today. I may have additional questions to submit to you. We appreciate the response you've given and, again, hope to work with you as we try to improve our civil service compensation and total package for Federal employees, and also meet our responsibility to the taxpayers. Thank you.

Mr. KELLY. Thank you.

Mr. SALISBURY. Thank you, Mr. Chairman.

Ms. STRANDJORD. Thank you, Mr. Chairman.

Mr. MICA. I will call our second panel. We have a change here. Since I probably mispronounced his name, he's not going to show up. [Laughter.]

With the Hay Group today, we have Michael Carter, instead of Abe Zwany; John Sturdivant, again, president of the American Federation of Government Employees; and Wendell Cox, with the Wendell Cox Consultancy. Welcome, gentlemen. As is customary, as soon as Mr. Sturdivant makes his way through the crowd, if you would continue standing, I will go ahead and swear you in.

[Witnesses sworn.]

Mr. MICA. The witnesses answered in the affirmative.

Again, welcome to our subcommittee. We ask, for the newcomers, that you try to summarize your comments. It will leave more time for questions, and we will make your entire written statement part of the record.

With that, we'll recognize Michael Carter, who's substituting for Abe Zwany. You're also with the Hay Group. We've already heard a little bit about some of your ideas, and give you this opportunity to be recognized and elaborate.

STATEMENTS OF MICHAEL F. CARTER, SENIOR VICE PRESIDENT, HAY/HUGGINS CO., INC., THE HAY GROUP; JOHN N. STURDIVANT, NATIONAL PRESIDENT, AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES, AFL–CIO; AND WENDELL COX, PRINCIPAL, WENDELL COX CONSULTANCY

Mr. CARTER. That's correct. Thank you. Mr. Abe Zwany is accompanying me, and I assure you he didn't back out just because you mispronounced his name.

Thank you, Mr. Chairman. My name is Michael Carter, and I am here with Abe Zwany. We are both officers of the Hay Group, a worldwide human resources consulting firm. We appreciate this opportunity to give you some quick observations about how the private sector structures compensation and benefit programs, and we ask that the full statement be entered into the record.

Mr. MICA. Without objection, so ordered.

Mr. CARTER. We'll summarize that statement in the next few minutes. Given intense domestic and international competition, organizations have realized the need to take a strategic perspective toward their investments in compensation and benefits and seek to maximize the return from their investment in total compensation, sometimes referred to as total remuneration. That is the sum total of all reward components, which would be base salary, annual incentives, long-term incentive benefits, and executive perquisites.

Companies have come to realize that they need to align their strategies and goals, work cultures, and human resource management systems in order to obtain maximum return on investment. The primary method that they have been looking to accomplish this, in addition to aligning their total remuneration package properly with their work culture, is to focus more attention on focusing compensation more on organization, unit, and employee performance.

For example, organizations are extending incentive pay programs to larger segments of the total employee population. Perhaps more importantly, they are implementing new programs which focus more precisely on the performance they expect of employees by paying for competencies or quality or for working effectively in teams.

These newer programs focus on base salary, as well as incentive plans. It's important to recognize that such innovative programs, adopted by prominent organizations in both the public and private sectors, are met with significant employee acceptance, as a result of survey data that we have, and do seem to contribute to improved organizational performance. Where properly implemented, such programs do work.

Turning to benefits, as we've heard in the first panel, organizations have been refocusing their benefit programs to meet the needs of a diverse work force. Our survey data of medium and large organizations shows that, over the last 10 years, there has been significant growth in flexible benefits programs and in personnel policies oriented toward individual and family needs of employees.

For example, we've seen growth to the point where most medium- and large-sized U.S. employers provide flexible spending accounts, and one out of five medium- and large-sized employers have a full cafeteria plan, and more than one-third of very large employers have a full cafeteria plan.

In addition, organizations have been orienting their benefits to the mobile work force. Employers recognize that they have a mobile work force, and employers in a very competitive market are increasingly becoming aware that they cannot have a cultural orientation where they are generally guaranteed job security. As a result, they've been focusing benefits to the more mobile work force.

A key component of that has been the shift from the defined benefit to the defined contribution plan. Mr. Salisbury indicated that there has been a de-emphasis there, that employers have not been improving defined benefit plans. In addition, our survey data show that there has been a drop in the prevalence of defined benefit pension plans. That is, some employers have chosen to discontinue them.

It should be noted, however, that particularly among very large employers, the typical practice of medium- to large-sized employers is still to have both a defined benefit and a defined contribution plan.

Another aspect of trying to manage the work force is that we've seen continuous activity in employers offering early retirement windows, as the Federal Government has recently done, where employers provide a financial incentive for employees near retirement to retire early. This serves to reduce the work force and, also, stimulate promotional opportunities.

In terms of cost containment, employers' focus has primarily been on the shift from traditional fee-for-service medical plans to managed care plans, such as PPO's, HMO's, and point-of-service plans. This strategy is apparently working, because our data shows a dramatic drop in the increases in costs of medical plan in the last few years.

Another significant component is that the orientation of compensation for performance is not limited to pay plans. Our survey shows that, of the for-profit organizations in our data base, almost one-half of them have a capital accumulation plan that is either based on performance or on stock ownership.

In summary, organizations are increasingly planning and administering reward systems on a total compensation or total remuneration basis, recognizing the important interrelationship. Pay is becoming more strongly linked to performance. In the area of benefits, employer costs have risen gradually as a percentage of payroll in the last 10 years, in part due to statutory cost increases.

Employers have been revising their benefit programs to be more dynamic and effective, more flexible, more oriented toward performance, more family oriented, and more attractive to and suitable for a more mobile work force.

We thank you again for the opportunity to address the subcommittee, and we'll be happy to answer any questions later. Thank you, Mr. Chairman.

[The prepared statement of Mr. Carter follows:]

Statement of:

Michael F. Carter
Senior Vice President
Hay/Huggins Co., Inc.
The Hay Group

Abram Zwany
Vice President
Hay Management Consultants
The Hay Group

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to address the Subcommittee on Civil Service of the Committee on Government Reform and Oversight on the issues concerning how private sector employers structure their salary and benefits programs. We are both officers of the Hay Group, a world-wide human resources consulting firm. Mr. Carter specializes in benefits and Mr. Zwany specializes in compensation. First we discuss how many organizations strategically structure their compensation and benefits packages in an integrated "total remuneration" context, and then we focus on specific compensation and benefits trends and issues.

The information provided in this statement is based on the Hay Group's more than 50 years of experience in compensation, over 80 years in benefits, and our personal combined 50 years experience in consulting to private and public sector organizations, as well as data from proprietary surveys and public sources. Specifically, compensation data are from the Hay Compensation Report (HCR), an annual survey of the compensation practices of almost 1,000 employers. Benefits data are from the Hay/Huggins Benefits Report (HHBR), an annual survey of the benefits practices of over 1,000 organizations. Both surveys sample various U.S. industries, geography, and medium, large and very large size employers. Small employers (less than 100 employees) are not represented, so our comments will not pertain to these organizations. All the data provided in this statement are from those two reports unless otherwise indicated.

Strategic Management of Compensation and Benefits

Background

In recent years, public and private sector organizations alike have struggled with the need to change. This need to change derives from both external factors, such as increasing global competition, the pace of technological innovation, pressure to reform and improve, and internal factors, such as changes in the nature and expectations of today's workforce Gradually, we have witnessed realization of the need to strategically manage compensation and benefits programs, and recognition of the importance of properly employing compensation and benefits programs to help create, support and communicate effective organization change.

Compensation and benefits are now being viewed as significant investments, rather than simply as unavoidable costs of doing business; consequently, organizations have begun to take a strategic perspective toward maximizing their return from these large investments.

Two of the main outcomes of this strategic perspective are:

- realization that compensation and benefits ought to be managed together, within what we term the overall reward, or Total Remuneration perspective, and

- recognition of the need to develop a properly-tailored compensation and benefits strategy, consistent with and supportive of the organization's business and financial strategies, its work culture, and its human resources management systems. In other words, organizations have come to recognize the value of developing carefully designed reward programs that fit their particular circumstances -- an evolution to more dynamic, people and performance-oriented compensation and benefits strategies developed within the context of clear organizational strategies and goals.

Total Remuneration

Many organizations have come to recognize that compensation and benefits are interrelated and that the total employee "reward" program needs to be planned, evaluated, structured, administered and communicated on an integrated basis. The rationale is that the organization's substantial investment in total employee rewards can be managed most effectively, and generate the greatest return for the organization, if it is managed as a carefully tailored and completely integrated package. Thus, many companies have modified their overall strategies, including their employee reward strategies, to consider compensation and benefits together as the components of a "Total Remuneration" (Total R) package. The Total R package includes base salary/wages (hereafter referred to as base salary), variable annual cash (e.g., cash incentive or bonus), long term incentive (typically just for executives), benefits, and executive perquisites (cars, clubs, etc.).

Under this approach, an organization would assess its Total Remuneration position in relation to its competitors for employees. It then determines the appropriate mix for its package (e.g., the proportion of cash *versus* benefits, how the cash compensation is delivered, how the benefits package is designed) in light of the organization's business and financial strategy, its work culture, and its human resource management systems. For example, an established, security-oriented company in a stable marketplace may wish to have average base salary levels, below average annual incentive, and above average benefits -- resulting in an average Total R practice. In contrast, an entrepreneurial firm bent on growth may also have an average Total R practice, but one designed to further its goals, by establishing below average base salary, very high annual incentive to motivate performance and growth, and below average benefits levels.

Designing Appropriate Total Remuneration Strategies

We have found that the effectiveness of reward strategies, be they integrated or focused on compensation and benefits separately, depends upon their alignment with organizational strategies and mission, work culture, and the other human resources management strategies employed. In fact, all three of these factors need to be carefully defined and aligned with one another in order for an organization to achieve superior performance. The following sections discuss the links between organization strategy, work culture, and Total Remuneration (compensation and benefits) strategy.

Organization Strategy

This refers to the organization's business and financial goals, including its competitive and financial strategies as well as a clear statement of mission for the organization overall, and sub-elements where appropriate. Better-performing organizations have clear mission, strategy and goal statements which are effectively communicated to employees and which lay out clear road maps for where they are headed, and how they intend to get there. These strategies determine the appropriate work cultures, which in turn drive optimal Total Remuneration strategies.

Work Culture and Total Remuneration Strategy

Work culture defines how people within organizations interact with each other, interface with customers and suppliers, and do their jobs. Work culture is demonstrated by organizational values and individual behaviors (e.g., competencies) and perceptions. We have identified four distinct work culture models that are characteristic of most organizations today. While complex and evolving organizations are often characterized by fluid combinations, or intersections of these models, the models themselves serve to highlight the importance of properly matching integrated reward systems -- Total Remuneration systems -- to work culture. The four work cultures, and the implications for integrated compensation and benefits programs are summarized below.

> ***Functional*** organizations are the most well-known organizations, and probably still comprise the majority of private and public sector organizations extant today. Functional organizations emphasize the reliable application of specialized technologies/processes, and attempt to limit risk. Work in functional organizations is divided into relatively narrow, specialized positions, and it is organized and controlled by the use of deep management hierarchies and many rules and regulations. The individuals who best fit into such organizations value professional expertise, security, order and stability; and they expect a long-term relationship

with a paternalistic employer. We should note that this traditional, hierarchical culture has evolved, in some settings, so that some of the more negative elements, such as rigid command and control structures have been replaced with more positive approaches that emphasize people and performance.

Clear Total Remuneration implications flow from the functional model. Overall, the level of Total Remuneration is set in relation to marketplace levels so as to attract, retain and motivate employees with adequate skills and knowledge. The strategy is to reward increasing levels of specialized knowledge over the life of a career in order to build reliable delivery of technology. The compensation system is keyed to the use of fairly narrow grades and ranges for base salary, with target levels keyed to the desired position in the marketplace. Internal equity of compensation is an important value; and salary progress depends upon sustained performance (often called merit pay) and movement of the salary ranges. Variable pay is limited to a small minority of employees -- usually those at the top. Benefits levels would typically be at or above average, and oriented toward security and service; for example, retirement would be career-based and service-related, health benefits would be uniform with low cost-sharing, and vacation benefits would be high and service-based.

Process organizations focus on their customers and continuous improvement. The work is organized into customer-driven processes, teams rather than individuals are the key unit of performance, and performance is normally measured in terms of progress, rather than specific, discrete events. Performance is measured through customer satisfaction and process benchmarking. Process organizations therefore value service, affiliation, influence rather than direction, and tenacity. Much of the recent change seen in both private and public sector organizations involves the attempt to change from a traditional bureaucracy to a customer-focused, streamlined, empowered, team-based model -- shifting from the functional to the process model.

Process cultures seek to reward employees for developing and making contributions to the team-based process. Employees share in group rewards (based on customer satisfaction) in order to cultivate reliable deliveries that fulfill customer needs. Process work cultures employ wider grade and salary ranges for most levels than do functional organizations. Salary progress depends upon demonstration of knowledge of the process, and market movement of ranges. More pay depends upon performance: variable pay plans are inclusive, often encompassing 80% or more of all employees in team or group-based bonus/incentive plans which are supported by continuous performance feedback and communication about results. Payouts are often quarterly, rather than annual, to support the process organization's need for continuing communication about performance and progress. Retirement plans are keyed to company performance (profits), and there is greater cost sharing on health plans, less life insurance, and less vacation than in functional work cultures. Exhibiting less of a paternalistic approach to benefits relative to functional cultures, process organizations would have lower overall levels of benefits, and more flexibility and profit orientation.

Time-Based organizations are designed to quickly exploit flexible technologies in order to dominate markets and maximize return on investment in assets. Such organizations are found in financial services as well as manufacturing. Work in these organizations is organized around multi-functional program teams, and relatively flat management structures are used to facilitate speed and flexibility. Time-based organizations value self-confidence, initiative, flexibility, and the desire for personal impact. Performance in measured in terms of "speed to market" and market share.

Time-based organizations emphasize flexibility in almost all aspects of their Total Remuneration programs. They focus on ensuring the availability of the talent necessary to achieve schedule, cost and productivity targets. Time-based organizations normally employ broad salary ranges where movement (salary growth) depends upon recognition of, and the importance of, the competencies of an employee as well as the performance of the team and program results. Similarly, benefits levels are lower and more flexible than in the process model. Retirement plans emphasize profit, portability and short-service; health insurance is flexible and usually calls for more cost-sharing with the employee; life insurance levels are minimal, and vacation benefits are low and depend upon position rather than length of service.

Network cultures, also known as virtual organizations, are designed for maximum flexibility and mobility. They normally focus on innovation, and the creation and exploitation of new markets. The roots of virtual organizations can be found in the entertainment and construction industries, among others. Network organizations are expressly designed to adapt to constant change. The work is venture-driven, and varies according to specific role in a particular situation. There are few if any formal structures, and initiative, creativity and pragmatism are valued. Additionally, influence and value attach to critical competencies, and the ability to build relationships.

Network organizations set their Total Remuneration so as to enable them to attract the specialized talent and supporting staff necessary to produce innovative ventures that meet immediate customers' needs through the flexible configuration of various assets. The focus is on the very short term. Network organizations have limited compensation and benefit structures. Supporting employees are paid minimum rates, while the critical employees are paid the levels necessary to attract them to the endeavor. Variable pay is provided to some 20-40% of employees, and the target payout level is 60% or more of base salary, paid after completion of the venture. Network organizations have minimal if any retirement programs, very flexible health care benefits (with high cost sharing), minimal life and disability insurance, low vacation and only basic holidays off.

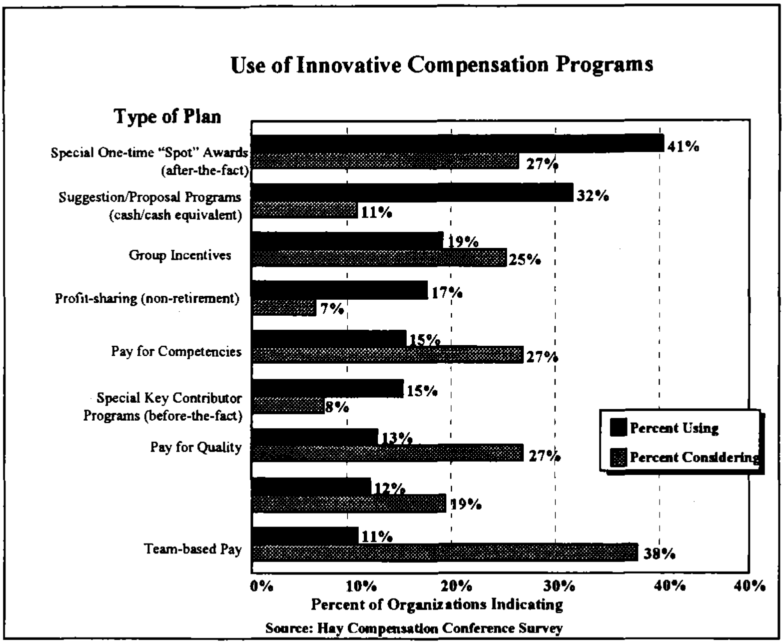
In summary, we find that high-performing organizations today clearly define and articulate their goals and strategies, create work cultures which support those strategies, and develop Total Remuneration designs which are aligned with and reinforce those work cultures. As a consequence, compensation and benefits programs today are more dynamic, people and performance-oriented: pay is becoming ever more closely tied to carefully-defined and measured performance.

Recent Trends in Compensation and Benefits

Compensation

Program Innovation

The effects of trying to tie pay more closely to performance are most clearly seen in the prevalence of innovative compensation programs (mostly but by no means exclusively incentive plans). There is a continuing trend to extend annual cash incentive programs to more employees -- by extending the breadth of coverage to include more units, and by extending the depth of coverage to all levels of employees, rather than just managers. But there is also a great deal of activity in the use of more innovative programs. The following chart depicts use, and consideration of various compensation programs which transcend the traditional "merit salary increase" approach.



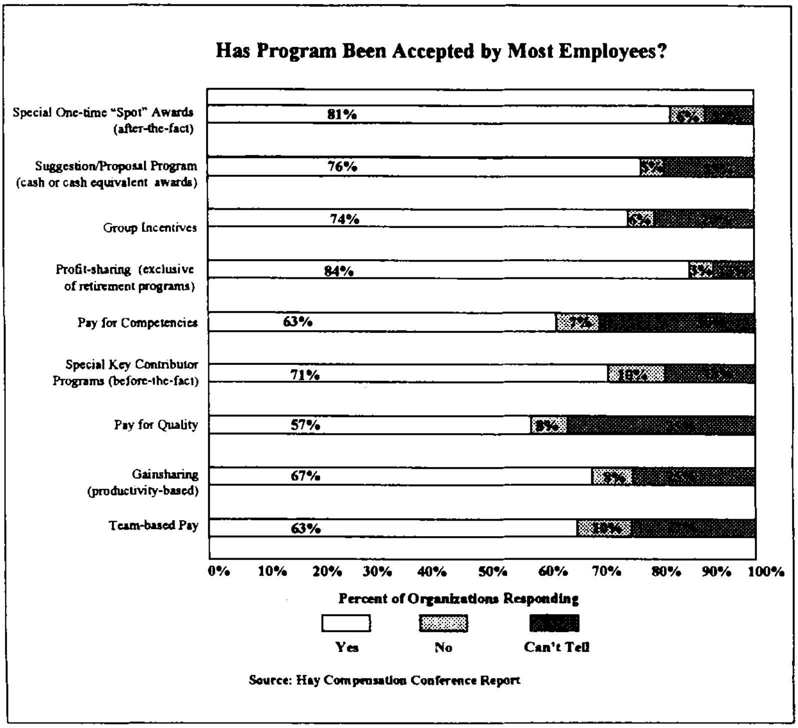
As can be seen from the chart, after-the-fact spot awards are most prevalent; and while not noted as strong motivators, such programs can certainly be an appropriate option under the right circumstances.

Process model-related incentives, keyed to quality/employee participation/employee empowerment (i.e., suggestion/proposal programs) are becoming more prevalent. Also, group incentives are becoming more frequent, while profit-sharing unrelated to retirement is becoming less frequent.

A variety of much more ambitious and complex plans fall near the bottom of the chart in terms of usage, including pay for competencies, pay for quality, pay for team performance. But more and more companies are considering implementing such programs, because they can be tailored to reinforce very specific company strategies and values, and alter individual and group behavior. We expect significant growth in these areas as companies reengineer work and come to rely more on the development of competencies, or organize more around teams. Leading edge organizations in both the public and private sectors are taking such approaches, and implementing pay for competency programs, for example.

Acceptance of Innovative Programs

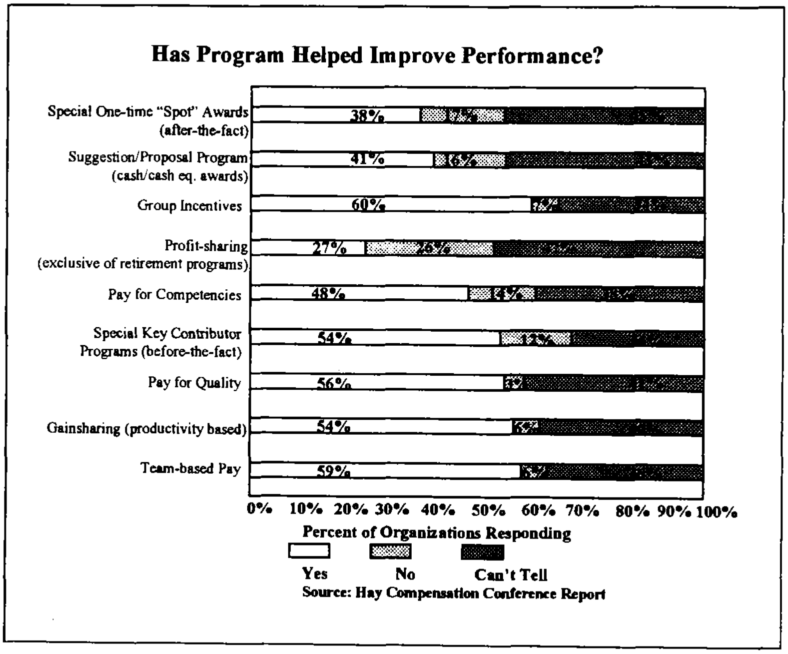
Perhaps even more revealing than widespread experimentation with alternative pay programs is the acceptance of newer plans by employees, as reported by human resources professionals. As the chart below shows, every program is reported as being accepted by the majority of the population.



Note that the programs in which employees have no pay at risk (e.g., one-time spot awards, profit-sharing plans and suggestion programs) are particularly popular, while the more innovative and demanding programs (e.g., team-based pay, gainsharing, pay for quality, and pay for competencies) are less well accepted.

Innovative Programs and Performance

Not surprisingly, there is no strong relationships between program acceptance and program effectiveness. For example, spot awards, suggestion programs, and profit-sharing programs -- which are popular with employer and employee alike -- are not perceived by human resources professionals as helping improve performance (see figure below).



In contrast, group incentives are seen as most effective, which seems to be attributable to the fact that the employees can directly influence the performance they are measured on in such programs (a cardinal rule of good performance management plan design). Similarly, team-based pay, and pay for quality also are perceived as effective. Other plans also are seen as relatively effective.

One of the most distressing things in the chart is the large percentage of respondents who don't know if such programs have helped performance. We would hope that all organizations have incorporated self-assessment plans into their new compensation programs, and that the "don't know" responses are therefore due to the newness of the programs.

If this is true, then it seems that: (1) organizations are indeed implementing a variety of innovative compensation programs which are specifically focused on motivating and rewarding the kinds of abilities, behaviors and outcomes which will support their desired work cultures and strategic initiatives; (2) that such programs are generally well-accepted by employees, and (3) that such programs are seen as effectively meeting the goals established for them.

Benefits

Private Sector Benefits Cost and Comparison to Federal Benefits

According to the Hay/Huggins Benefits Report (HHBR), the average 1995 cost of benefits expressed as a percentage of payroll(salary) is shown below, broken out by major plan area and generally shown in descending order of cost. The cost shown is the employers' net cost, i.e., the cost remaining after reducing the total cost for employee contributions. The cost shown for the plan breakouts is the arithmetic mean of all respondents including those with no benefit plan. Thus the average cost is higher just for those respondents with a plan where plan areas are not universal: retiree health, defined benefit pension and capital accumulation.

Costs are shown for all benefits *other than* paid time off, e.g., vacations, holidays and uninsured sick days. Using a "cost" of a day's pay for a paid day off, based on 5 work days a week and 52 weeks per year, the additional "cost" for vacations, holidays, and uninsured sick leave averages about 13% of pay. This would result in a "total cost/value" of general and paid time off benefits equal to 39% of payroll (26% + 13%).

Statutory benefits includes Social Security, workers' and unemployment compensation. Retiree health benefits is the actual annual cash payment and not the required accounting expense (FAS 106).

Capital Accumulation plans refers to any *Defined Contribution* plan including 401(k), 403(b) tax deferred annuities, post-tax savings plans, profit sharing plans, discount stock purchase, stock bonus, broad-based (not executive only) stock option plans, money purchase, and Employee Stock Ownership Plans (ESOPs).

Disability benefits include statutory state short term disability plans. In addition to long term disability, they include insured short term disability, but not uninsured short term disability or sick days. "Other" benefits includes food cafeteria, child care, severance pay, tuition reimbursement, subsidized facilities, activities, etc.

Employer Benefits Cost Expressed as a Percentage of Payroll

Plan Type	Percentage of Payroll (Salary)
Statutory Benefits	8.44%
Health Care Benefits for Active Employees	8.35%
Health Care Benefits for Retirees	0.81%
Defined Benefit Pension Plans	2.94%
Capital Accumulation (Defined Contribution Retirement/Savings Plans)	3.38%
Death Benefits	0.59%
Disability Benefits	0.57%
Other Benefits	0.87%
Total Benefits	25.95%

The cost has gradually increased from 24.55% in 1985 to 25.95% in 1995. During that time, statutory cost increased 0.73% of payroll from 7.71% to 8.44%. This increase is about half of the 1.40 percentage point overall difference (25.95% - 24.55% = 1.40%). It appears that increased statutory costs did *not* cause a reactionary reduction in non-statutory benefits cost levels.

Employer costs vary widely. While the average is a 25.95%, the 10th percentile is 17.13%, the 25th percentile is 21.15%, the 75th percentile is 30.03% and the 90th percentile for net benefits cost is 35.31%. Thus there is a 42% difference between the low and high end of the middle half of the companies (25th compared to 75th percentile: 30.03% / 21.15% = 142%).

There are differences by industry, size and region. Chemical/petroleum, financials, utilities/transportation and heavy manufacturing companies have the highest benefits cost levels while high technology and service organizations have the lowest levels. As one would expect, cost levels generally increase with firm size. Cost levels are highest in the northeast, mid-atlantic, central and western regions and lower in the south and plains states.

As part of our ongoing benefits consulting services to the Congressional Research Service, Hay has conducted comparisons of private sector and federal benefits. Our most recent comparison conducted in February of this year, showed the following major findings:

- Federal benefits are higher in aggregate than private sector employer benefits.

- The federal advantage in retirement/savings benefits is the major reason for the overall advantage.

- Federal vacations and holidays are higher than average private sector practice.

- Federal health care benefits are lower than private sector average practice due to higher than typical federal required employee premium contributions.

Orienting Benefits to Workforce Needs

Earlier in the century, employers generally developed their initial benefits program to meet the needs of a long service male employee with a non-employed spouse and dependent children. In the last two decades, most employers revised their programs to better meet the needs of a diverse workforce.

One change has been the move to flexible(flex) or "cafeteria" benefits. One type of flexible benefit is the flexible spending account. These accounts allow employees to reduce their federal income and Social Security taxes on amounts that pay for premium contributions, unreimbursed health expenses, and dependent care expenses. Another form generally referred to as a "full" cafeteria or flexible benefits plan provides significant choices of benefits. These plans are usually in the form of a core of fixed benefits and "credits" that can be used to purchase benefits from a "menu" of choices. In addition, some employers have "simple" flex plans without credits but some choices such as choice of high and low medical plans.

The table below shows the growth of flex plans in the last ten years. The "Choice of Fee-for-Service Plan" category refers to choice of two or more fee for service medical plans with various levels of benefits such as a high/low option. This does *not* include the common situation where companies offer a choice of a fee-for-service and another type of medical plan such as Preferred Provider Organization (PPO), Point-of-Service (POS), or Health Maintenance Organization (HMO). The prevalence of flex plans increases with company size with 36% of firms with over 10,000 employees providing a full flex plan compared to only 7% in firms with less than 500 employees.

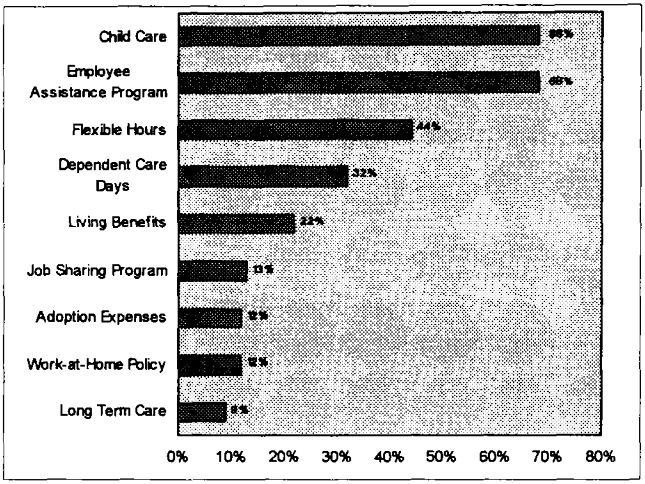
Growth of Flexible Benefit Programs

(Percentage of Organizations Providing A Plan)

	1985	1987	1989	1991	1993	1995
Flexible Spending Account	6%	25%	38%	68%	73%	76%
Choice of Fee-For-Service Plan	4%	14%	18%	25%	30%	29%
Full Flex Plan	2%	9%	11%	14%	18%	21%

In addition, many companies have implemented family oriented benefits as shown in the table below.

Family Oriented Benefits



Benefit programs were initially designed with a long service orientation under the assumptions that many employees wished a career with one company and that the employer could offer reasonable job security. Such benefits included defined benefit pension plans that focused benefits on long service retirees, strong replacement income protection in the event of death and disability, family medical benefits, and service-based benefits.

The current employment environment is very different with a mobile workforce (although less so during economic downturns). Moreover, many companies are no longer willing to make commitments to job security as they manage their costs to succeed in very competitive domestic and international markets.

As a result, companies have changed benefit programs to be attractive to a more mobile workforce. The most significant change has been in the area of retirement benefits. In 1985, a full 87% of HHBR participants provided a defined benefit pension plan. This has dropped steadily to 64% in 1995. The prevalence of defined benefit pension plans varies by company size with 82% of firms with over 10,000 employees providing a plan compared to only 45% in firms with fewer than 500 employees.

In contrast to the decline in the defined benefit pension plan, employers have been adopting and improving capital accumulation (defined contribution) plans in significant numbers in the last decade. In 1985, 72% of companies had one or more capital accumulation plan, compared to 98% in 1995.

Capital accumulation plans appeal to mobile employees because they understand them better and value having an individual account balance. In addition, these plans are portable; that is, they can be rolled over into an IRA and sometimes a subsequent employer's plan.

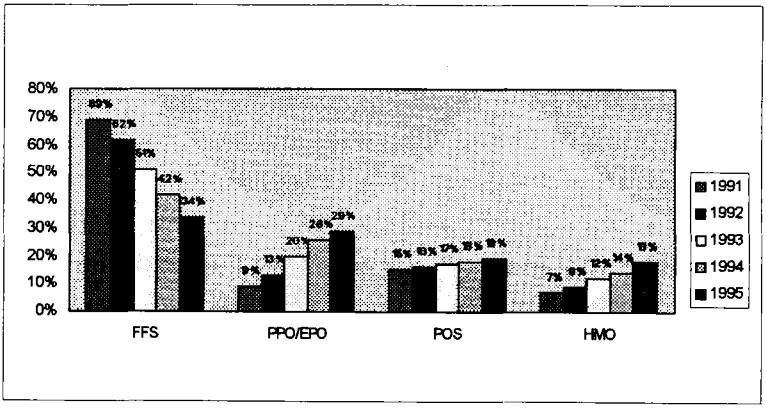
Employers have also used benefit plans to offer early retirement "windows" where employees are provided a financial incentive to retire early. This reduces labor costs and allows for promotional opportunities. In 1995, twelve percent of HHBR participants reported offering an early retirement window in the last 12 months, compared to 15% in 1994, 16% in 1993, and 17% in 1992.

In addition to the retirement changes, employers have refocused their programs away from *fixed* security to benefit choices where non-security benefits, e.g. paid time off, might be selected.

Cost Containment and Orientation to Company Performance

Employers have been actively involved in cost containment efforts. Much of the focus has been on health care benefits cost containment. The major emphasis in the last five years has been to move away from traditional fee-for-service (FFS) plans to managed care plans: preferred provider organizations (PPO), point-of-service plans (POS), and health maintenance organizations (HMO). The table below shows the significant movement away from FFS plans to managed care in the last five years. The chart shows the prevalence of employers' "primary" plan, defined as the plan with the highest percentage of participants. Since 1991, the prevalence of FFS primary plans has been cut in half.

Design of Primary Medical Plan



Companies are also increasingly orienting benefits to company performance and ownership. Almost half (47%) of for-profit companies have one or more performance-based capital accumulation plan. Indeed, 10% have more than one. Twenty-three percent offer a deferred profit sharing plan and 13% have a profit-based match to a 401(k) plan. Thirteen percent have Employee Stock Ownership Plans (ESOPs) while 11% have discount stock purchase plans where employees can purchase company stock at a discount. A small number (5%) have broad-based employee stock option plans. Similar to executive stock option plans, these plans permit employees to purchase stock in the future at the current price. If the stock price rises, then the employee can purchase the stock at a discount.

One other method of benefits cost containment is a by-product of changing the compensation mix to have lower base salary and higher annual incentive. If benefits are based only on base salary, then the benefits costs, which are a function of base salary, are similarly reduced. If benefits are based on base salary plus incentive, then the benefits costs related to the incentive portion are only incurred when the incentive is paid -- when company/unit and/or individual performance has been good.

Taxation Impact on Benefits

Like other situations, tax policy drives employer and employee actions in the benefit area. It is widely considered that employers offer the current extensive types and amounts of benefits because of favorable tax status to the employer and employee. The strong prevalence of tax deferred savings plans compared to the lesser prevalence of post-tax savings plan is but one example. It seems likely that employers would focus total remuneration budgets more on cash compensation if the more favorable tax status for benefits was reduced.

Summary

It appears that employers have come to recognize the need to strategically manage their overall reward programs on an integrated basis in order to maximize the return on these large investments. Employers are clearly defining their business and financial strategies, and then articulating the work cultures which best support and reinforce those strategies and goals. In turn, compensation programs which align with, and positively contribute to, the desired work culture are being developed and implemented, and most of these programs focus on clearly tying contingent rewards to desired abilities, behaviors and outcomes. More than ever before, organizations are carefully defining what it is they need and wish to pay for, from a sound theoretical foundation, and making more and more of total compensation contingent upon employees' performing appropriately.

In the area of benefits, employer costs have risen gradually as a percentage of payroll in the last 10 years in part due to statutory cost increases. Federal employee benefits are more competitive than private sector benefits. Employers have been revising their benefit programs to be more dynamic and effective -- more flexible, performance-oriented, family-oriented, and attractive to and suitable for a more mobile workforce.

Thank you for the opportunity to address the Subcommittee on Civil Service. We will be happy to address any questions concerning these issues.

Mr. MICA. Thank you, Mr. Carter.

Mr. CARTER. Look at that timing.

Mr. MICA. Fantastic. I would like to welcome back Mr. Sturdivant, who put everything on the table last time and is back to offer another deal. Welcome back.

Mr. STURDIVANT. Thank you, Mr. Chairman. I am glad to be back, glad that you invited me. I'm John Sturdivant, president of the American Federation of Government Employees, one of your friendly employee groups, speaking on behalf of our members and the people that we represent.

My staff has prepared a well-researched and scholarly testimony that I can't add anything to it, so I would just ask that it be entered into the record.

Mr. MICA. Without objection, so ordered.

Mr. STURDIVANT. I would just, maybe, have a few comments, with the idea that, perhaps, after we hear from the other panelists, we can engage in some give-and-take. I was heartened by your comment earlier that the purpose of these hearings is to improve civil service benefits. Once you and I can agree on what "improve" means, then perhaps we can put something else on the table.

I would just say, though, that given, as you know, we have been having these discussions all year on various benefits of Federal employees, and I believe that, at the beginning of the year, you started out with the position that we had too much, and I started out with the position that we had too little, perhaps, with some dialog, we can reach some understanding of just what we have.

I would suggest that, when we are looking at the Federal Government, we compare the benefits with a large private sector high-performance workplace, someone like Xerox, AT&T, IBM, Marriott, or even some States, such as New York City or California. After all, the Federal Government is the largest employer in this country, and we have people who do all types of work.

We have people who are researching and looking for a cure for cancer and AIDS. We have people who are working on sophisticated military equipment. We have people who are involved in making sure that Social Security beneficiaries get their checks on time. We have individuals who are making sure that drugs and contraband do not get in the country.

And, of course, we want to retain and recruit the most highly qualified, the most competent, the most highly innovative employees that we can.

We do not want to compare the compensation system—and although I don't have anything against McDonald's or 7–11, we don't want to compare the compensation system with those types of employers or some mom-and-pop store. These are not individuals who are flipping hamburgers, although I do have some members who flip hamburgers, and I would submit that, under the current wage grade system, they are not paid right, either.

I would also point out, Mr. Chairman, that on health insurance, I think it's well settled—and I'm sure that there will be some disagreement—that, basically, the Federal Government pays $1,100 less than the average private sector employer.

On pay, I thought—in 1970, we had a good, bipartisan agreement between a good Republican President and a good Democratic Congress, and we reached an agreement on pay where we would tie pay closer to the private sector.

I think the unions made a decision to get away from the one size fits all, and we recognized that the Federal Government could pay at a market rate. That's a system that has not been allowed to operate the way it should have. Otherwise, we would not have the problems that we have in pay.

As far as civil service retirement is concerned, Mr. Chairman, you know that you and I have had our disagreements over that particular system, but the CSRS system is a defined benefit system, but the FERS system is a defined contribution system. I thought we fixed that particular benefit in 1984, when we grandfathered the CSRS people into the system and then began having people come into FERS. So I don't know where we are on that, as far as what the problems are.

I would point out that there are some particular different aspects of setting pay and compensation in larger, more progressive States, and we do take into account data from the State and local area when we do our rate surveys. There's a process that we call collective bargaining that's used in a lot of the States, and, of course, we would be open to having that discussion and maybe pursuing that, with setting pay and benefits.

I think, one other point I would like to point out on the Federal employee health benefits program is, the program is not perfect. It needs to be fixed; it needs to be refined.

I thought that the proposal, basically, this year, that would have taken OPM out of the business of negotiating and removing its negotiating power on the basis of Federal employees, was a little shortsighted, because, obviously, the Federal Government has negotiating power, and I think it can improve the system.

I think one of the other things that we need to take a look at when we take a look at the Federal employee health benefits program is that 400,000 Federal employees are not in that system, and the reason why—as a result of some surveys—is that they simply cannot afford it because of the cost-shifting and because of the increased cost.

So I look forward to working with you, Mr. Chairman, as we have dialog on these issues, and I look forward to working with you to improve the benefits for the members that I represent. Thank you.

[The prepared statement of Mr. Sturdivant follows:]

STATEMENT BY

JOHN N. STURDIVANT
NATIONAL PRESIDENT

AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES, AFL-CIO

Mr. Chairman and Members of the Subcommittee: My name is John Sturdivant, and I am the National President of the American Federation of Government Employees, AFL-CIO (AFGE). On behalf of the more than 700,000 federal and District of Columbia employees our union represents, I thank you for the opportunity to testify here today on the differences between federal and private sector compensation.

The question at issue is the adequacy of federal compensation in the wake of twenty years of cuts, freezes, and budget-driven "reforms." Historically, the intent has been for the federal government to provide compensation that is "comparable" to prevailing practice in the private sector. But salaries are still as much as 27 percent behind the non-federal sector. Health benefits continue to be inferior, and the measure of inferiority threatens to grow. Our retirement systems, the last remaining aspect of compensation which fulfills the promise of comparability, are under constant attack, having succumbed this year to cuts worth several billion dollars.

There is a great wealth of information available with which to assess the relative value of compensation packages in the federal and private sectors. There are also some non-quantifiable characteristics of compensation, such as pay-setting systems themselves, which have so great a bearing upon pay that they deserve to be included in any definition of compensation. I refer here to pay-determining factors such as pay-for-knowledge, pay-progression schemes such as longevity awards, productivity gainsharing, and job evaluation schemes which seek to reward speed, skill, experience, education, or which seek to address issues such as pay equity for women and minorities. All of these factors are widely used throughout the private sector, and directly affect pay levels for private sector workers.

I will restrict my testimony, however, to health insurance, the retirement systems, and pay because these have been the targets of the most misinformation, and because these have been the victims of so many budget cuts. It is necessary to take a close look at what remains of these programs, and ask: are they still comparable to private sector practice? Are they still capable of providing fair compensation for the ever-expanding workload of an ever-shrinking federal workforce? Have budget-driven reforms threatened their long-term prospects for comparability?

Health Insurance

The most recent comprehensive study comparing the value of health insurance benefits available to federal employees to those available to employees of large private sector firms was carried out by the Congressional Research Service in 1989 ("The Federal Employees Health Benefits Program: Possible Strategies for Reform," May, 1989). That study found that the federal government spent roughly $1,100 less per employee per year on health insurance than the typical large private sector firm. This variation was to a very small degree a function of a difference in the level of coverage (the private sector, on average, provided more comprehensive coverage); rather, it reflected the less generous financing by the government. Since that time, the CRS has updated its estimates of the variation in employer-financing between the Federal Employees Health Benefits Program (FEHBP) and typical large private sector firms and found that the size of the funding gap has remained the same from 1989 to the present.

The CRS study also offered several detailed comparisons between the FEHBP and its constituent plans and those offered by large private sector firms, such as General Electric (GE), General Motors (GM), IBM, Marriot, Xerox and others, as well as several public sector employers such as New York City and the State of California. In this way, CRS was able to compare not only differences in the level of employer-financing of health insurance benefits, but differences in the benefit packages as well.

Some of the unique practices of these other large private and public sector employers include: tying employee cost-sharing to salary (GE, Xerox), centralizing claims processing after formerly contracting with 74 separate carriers for this service (GM), self-insurance with no premium charges to employees and deductibles only for highly-paid employees (IBM), paying entire premium cost for basic coverage for employees and dependents to assure universal coverage of workforce (NYC), and flex plans to pay for health insurance costs out of pre-tax income (California and others).

The FEHBP does not include any of these features. Most notably, the FEHBP's relatively high premium costs for employees have left roughly 400,000 federal employees uninsured. These employees are eligible for participation in the FEHBP, but when surveyed by OPM -- have cited prohibitive costs as the reason for declining to participate.

The CRS study's concluded that "(O)verall, the private sector's total health benefit package is usually more generous than that available to federal employees, particularly with respect to the share of the premium paid by the employer, deductible amounts, and dental coverage." (1989 CRS study, page 134). Subsequent studies by the General Accounting Office and the private benefits consulting firms have confirmed these findings.

The proposals to change the financing system for the FEHBP which were briefly considered this fall would have only widened the gap between the health benefits received by federal workers under the FEHBP and those received by private sector employees. The factor most responsible for FEHBP's inferiority is the relative parsimony of the government's financing of premiums. Second is the size of deductibles and co-payments (out-of-pocket costs) which are almost universally higher for federal employees than for employees of large private sector firms.

Changing the financing formula from a dollar amount based on a percentage of the average premium of the largest plans, to a dollar amount based on average 1995 government contributions, adjusted annually on the basis of the Consumer Price Index (CPI) (a voucher approach), would have left federal employees and their families even farther behind the private sector. In any year when the rate of growth of premiums exceeded the rate of growth in the CPI, the government's share of premium costs would fall. Using rather optimistic assumptions about the rate of growth in premiums (seven percent annual growth rather than the 10 percent which has been the historical average over the last two decades) the Congressional Budget Office (CBO) estimated that in seven years the government's average contribution would fall from 72 percent to 55 percent.

At first glance it would seem ironic that the proponents of the voucher proposal chose the CPI as the adjustment factor for the government's contribution to premiums, when the same individuals have joined in the recent attack on the index's accuracy. An additional irony is that the CPI is a particularly inappropriate measure of the rate of growth of health care costs.

In a recent CBO study (<u>Is the Growth of the CPI a Biased Measure of Changes in the Cost of Living?</u>), sources of overstatement and understatement of inflation were examined. The CBO found that the health insurance component of the CPI counted as "costs of living" only the difference between premiums paid by consumers and benefits paid by insurance companies. In other words, the CPI measures increases in the cost of administering health plans and growth in insurance company profits. It does not measure increases in the costs of purchasing health care services; these are calculated separately. Thus the CPI was found to significantly underestimate increases in the cost of obtaining actual health care through the private insurance system.

In another study of this issue, the Bureau of Labor Statistics (BLS) used an experimental index with a different definition of health care costs: it showed that changes in insurance premiums increased 5.6 percent faster than the existing health insurance component of the CPI for the years between 1977 and 1983. The failings of the CPI to measure health care costs for individuals is difficult to translate into an estimate of the entire CPI. But the Economic Policy Institute ("Revising the Consumer Price Index: Correcting Bias, or Biased Corrections?"), estimates that if the CPI measured actual health care expenditures for the insured population instead of administrative costs and insurance company profits, the CPI would be increased by anywhere from 0.06 percent to 0.22 percent annually.

The BLS has also contended that the CPI understates inflation for the elderly because of the greater weight of housing and medical care costs in their budgets. When the CPI weights are adjusted to reflect the spending patterns of the elderly, the index rises 0.3 percent faster each year because health care costs rise more rapidly than the overall CPI, and because these costs constitute a higher than average portion of expenditures for this population.

Changing the financing formula for FEHBP into a cash voucher whose purchasing power for health care or health insurance would diminish in value every year is not only an open-ended compensation cut for federal employees, it has no precedent in the private sector. To the extent that the purpose of compensation policy is to enhance the government's ability to recruit and retain the very best people in a competitive job market, this change in the FEHBP is a federal recruiter's nightmare.

Another legislative proposal considered this year would have deprived the Office of Personnel Management (OPM) of the right to negotiate the terms of contracts with insurance carriers who wish to participate in the FEHBP. This misguided proposal would have the dubious distinction of giving the government and the taxpaying public less bang for more bucks. The FEHBP is the largest employer-sponsored health insurance program in the nation, which gives the government the opportunity to exercise tremendous bargaining power over the rates it and federal employees pay for health insurance. Mandating minimum levels of coverage mitigates the destructive and costly effects of adverse selection, which tend to occur in a competitive system like FEHBP's when there is no intervention to try to normalize benefit levels. Only when plans offer similar benefit packages does competition proceed on the basis of price and quality, and therefore promote cost containment and the interests of consumers. Taking away the government's ability to leverage its huge buying power simply makes no sense.

One last issue regarding federal practice in the area of health insurance: As the health care industry undergoes changes which have made managed care an inevitability for so many workers, both large private sector employers, and to an increasing degree OPM have taken steps to assure that plans be held accountable for quality and accessibility. To achieve this goal, large private and public employers are requiring managed care plans to seek and receive annual certification from independent quality assurance auditors, such as the National Center for Quality Assurance (NCQA). Requiring NCQA accreditation, conducting and responding to customer satisfaction surveys, and pursuing various quality and coverage issues are all ways in which OPM is following private sector practice in the provision of health insurance. Congress should not deprive OPM of these opportunities.

Retirement Systems

The two main federal retirement systems, the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS), have persistently been accused of exceeding private sector standards in the areas of retirement eligibility criteria, benefit formulas, accrual rates, and cost-of-living adjustments. The fact is that although comparisons among retirement plans are notoriously difficult (it is even difficult to compare CSRS and FERS to one another), the federal retirement systems are considered by experts to be comparable to those of large private sector firms.

This year both the Congressional Research Service and the General Accounting Office have studied the federal retirement systems in order to gauge the impact of various proposed changes. Comparisons to private sector practice were integral parts of these studies. The most straightforward comparisons use the bottom line for enrollees: benefits as a percentage of final salary. In other words, comparisons of the structural aspects of the different systems provide useful and interesting information, but from the perspective of employee compensation, what matters most is how much retirement income the system will provide.

There is wide agreement that the best data on this question has been provided by the Hay Group, which compared benefits as a percentage of final salary, holding age and length of service constant. In comparing benefits for the CSRS retiree, the Hay Group found that income replacement for a worker with a $40,000 final annual salary was lower for the CSRS worker than either the state government or private sector worker, at ages ranging from 55 to 65, and with service ranging from 10 to 30 years.

Benefits as a Percentage of Final
Salary for Worker Earning $40,000

Age	Years of Service	Private sector retiree	State retiree	CSRS retiree
55	10	12.2 to 14.0%	9.6%	None
55	30	38.8 to 45.5	35.9	56.25
62	20	45.6 to 48.7	40.5	36.25
62	30	65.1 to 70.3	57.8	56.25
65	20	53.9 to 56.5	48.5	36.25
65	30	74.2 to 77.3	64.5	56.25

Source: General Accounting Office, "Overview of Federal Retirement Programs," May 1995.

The differences presented here are considerable, but even these tell only part of the story because they include only benefits accruing to the individual worker and do not measure benefits relative to amounts paid into the system by the worker. For example, they exclude differences which derive from participation in the Social Security system. Social Security provides a spousal benefit of 50 percent of the primary benefit and is paid in addition to the primary benefit while both spouses are alive (unless the spouse is eligible for his/her own larger primary benefit). Upon the death of the primary beneficiary, the surviving spouse is paid the primary benefit. As CSRS workers do not participate in the Social Security system, they are not eligible for these spousal benefits. In fact, neither CSRS nor the FERS pension plan provides a spousal benefit while the retiree is alive, and survivor benefits in both systems are lower than the amount the retiree received before death.

According to the BLS, 90 percent of large private sector firms with defined benefit pension plans require no contribution from employees. They are one hundred percent employer-financed. After this year, CSRS employees will likely have to contribute 7.5 percent of salary, and FERS participants will have to contribute 1.3 percent of salary, exclusive of Social Security. To add insult to injury, these "contributions" will not go to finance federal retirement benefits. Rather, they are a compensation cut to federal employees which will go to pay for huge tax cuts targeted largely to wealthy individuals and corporations. Recently, AFGE has had to fend off proposals for even larger increases in employee "contributions" (which even the CBO has agreed is a tax increase on federal employees), as well as proposals to lower the government's matching contributions to the Thrift Savings Plan (TSP). These budget-driven "reforms" are at odds with private sector practice.

CSRS has been closed to new entrants since the end of 1983. FERS was established as a result of changes to Social Security which required that all federal employees hired after 1983 be included in the system. CSRS, established in 1920, is a defined benefit plan without Social Security coverage. FERS, implemented in 1987, was a conscious attempt to design a federal retirement system which reflected current private sector practice, and thus includes a combination of Social Security coverage, a defined benefit pension plan, and a Thrift Savings Plan (TSP). The TSP is a voluntary capital accumulation plan with some employer-matching, and is meant to offer portability and an opportunity to supplement the retirement income from the other two sources. FERS also differs from the CSRS in that COLAs are substantially lower.

CSRS and FERS are both well in the mainstream of private sector practice in terms of eligibility criteria for retirement with unreduced benefits. The fact that CSRS allows retirement with full benefits at age 55 with 30 years of service is cited by would-be reformers as exceptional. But both the Hay Group and the BLS employee benefits survey show that approximately half of plans in medium and large firms allow retirement with unreduced benefits at age 62 with 10 or fewer years of service. And some private sector plans do allow long-service employees to retire with full benefits before age 62. In fact, age 62 is both the average age for eligibility for full benefits in the private sector and the average age of retirement in both the federal and private sectors.

It should also be noted that of employers who use 62 as the minimum age for retirement, few require 30 years of service. Thus retirement age provisions must be considered in conjunction with length of service requirements. Considered in this context, both FERS (which has a minimum retirement age of 57 with 30 years of service) and CSRS are well in the mainstream, using BLS survey data.

Regular inflation-adjustments for CSRS and FERS annuities have frequently been characterized as "unheard of" outside the federal government. This is not true. Many public and some private sector employers provide regular COLAs for their retirees. Unfortunately, many private sector employers provide COLAs only in response to angry protests from retirees and their unions, or when media attention focuses upon the encroaching poverty (Seniors eating dog food in order to save money for their medications) of elderly "fixed income" recipients who may have provided 30 years of devoted service to a prosperous corporation. And of course, Social Security provides annual inflation adjustments, a feature which can be credited with protecting most elderly people from the type of poverty which was so widespread before the establishment of the program. While Social Security COLAs are always paid in full and on time, COLAs for federal retirees have been reduced, delayed and even cancelled several times over the past decades for political and budgetary reasons.

Unlike CSRS and FERS where annual COLAs are part of the systems' structures, COLAs in the private sector are rarely actual features of the pension plan. According to a Department of Labor study, between the years of 1973 and 1979, retirees in plans with at least 10,000 participants had received COLAs which compensated them for 57.2 percent of the change in the CPI in that period. Studies using data from the period of 1984-1993 have shown some improvement in this record, with most employers giving adjustments at least once during this period, but varying them on the basis of when the last COLA was received. The Labor

Department noted that these once-a-decade increases varied in size from 2-20 percent.

Some private sector practices should be condemned, not emulated, by the federal government. Failure to protect the value of earned pensions through regular COLAs (while at the same time lobbying for the right to withdraw "surpluses" from their funds for non-pension related purposes) is not an area of private sector comparability AFGE would like the government to pursue.

Any honest analysis of federal retirement benefits must conclude that they are roughly equivalent to those in large private sector firms: In some ways they are lower, in some ways they are higher, but all in all, they are about the same. The same can be said about CSRS and FERS; they are roughly comparable to one another. CSRS provides better inflation protection and lower risk than FERS; FERS provides Social Security and better portability than CSRS. They both represent deferred income earned by federal employees through years of work for their government but paid after retirement. Federal workers value their retirement systems, as should management, for they serve as effective tools for recruitment and retention of a high quality, devoted federal workforce.

<u>FEPCA and the General Schedule: Federal White Collar Pay</u>

The Federal Employees Pay Comparability Act, signed into law in 1990 by President Bush, (FEPCA) represents the most recent comprehensive reform of the federal pay setting process. FEPCA was a broadly supported bipartisan effort which reaffirmed that federal employees' pay should be comparable to nonfederal sector pay in order to recruit, retain, and motivate a highly skilled professional workforce which is responsible for carrying out the vast array of duties and responsibilities on behalf of all Americans.

Under FEPCA, federal pay is compared to that of non-federal (including employees in state and local governments) employees rather than only those in the private sector. The annual government adjustment has been separated into two components, a national and a local adjustment. The national component is designed to prevent federal salaries from falling further behind nonfederal sector salaries. This is accomplished by linking the annual governmentwide increase to the percentage increase in the Employment Cost Index (ECI). Locality adjustments are to be made based on pay disparities in local labor markets. Under the law, the pay disparities are to be eliminated over a nine year period. This pay setting process relies directly upon a position comparison method for gathering and interpreting the data needed to determine local pay comparability. The nonfederal pay data is compiled from annual Bureau of Labor Statistics Occupational Pay Surveys.

While current federal pay policy under FEPCA has its critics, AFGE believes that the pay comparability principle is the soundest method of setting salaries for the government's approximately two million workers. FEPCA has made major improvements in the pay setting process. These improvements include moving federal compensation to reflect local rates of salaries, widening the comparability process to include state and local government entities, providing Congress and the Executive Branch with the anticipated cost of salary increases early in the budget cycle, and providing agencies additional pay flexibilities to meet unique recruitment and retention problems.

It is important for those responsible for federal compensation issues to remember that any method that is used to arrive at a single comparability number, even in local labor markets, cannot be expected to apply with precision to every individual being compared. Any single number is an average of many differently paid individuals with different skills and responsibilities. The fact is that according to the 1995 report of the President's Pay Agent, the federal non-federal pay disparity still averages 22.58 percent. This varies from a high of 40 percent in Houston to a low of 17 percent as reflected in the wage area designated as "Rest of the United States."

The inability to substantially reduce the pay disparity since the enactment of FEPCA lies in the failure of the Executive Branch and the President to recommend pay increases in line with results of the survey process. This is not new. Virtually every President since Richard Nixon has used his authority to issue alternative pay plans under a variety of excuses. As a result, between 1970 and 1994 federal pay had declined in real terms by a total of 23.0 percent, due in large part to the failure of government to keep its promise of comparability. Since 1981, federal employees and retirees have given up more than $175 billion in lost wages and benefits for purposes of deficit reduction.

The failure to deliver on the promise of comparability between federal and non-federal pay has not been a bargain for taxpayers. As the federal workforce ages and is downsized, retirements will force the government to recruit new employees to take on a workload which is increasing in size and complexity. To be successful in recruiting and retaining a high quality workforce, the government will have to offer pay which is competitive with that offered in the market. If the government continues to refuse to follow even the slow path to comparability set forth in FEPCA, it will have undermined its own objectives, at the same time it has undermined the living standards of two million federal workers.

Private corporations typically have an explicit or implicit compensation strategy regarding their own pay levels relative to the prevailing rates. It is not unusual for large corporations to set their pay targets above or beyond average competitive rates in order to maintain world class leadership in keeping skilled employees. By contrast, the federal government policy has remained constant over the last 50 years to pay workers somewhere near the average or mid-point of rates paid workers in the same labor pool.

It is important for federal policy makers to realize that both the federal government and private industry rely heavily on salary surveys to define the parameters of salary schedules. For federal workers under FEPCA, the government is required to use annual wage surveys produced by BLS. These surveys are the most sophisticated and unbiased source of wage data that exist. Because of their unparalleled quality, many large corporations also rely on the BLS wage surveys in the ongoing administration of their salary programs.

The Federal Wage System: Federal Blue Collar Pay

The Federal Government's 294,000 craft and trade employees are paid under the provisions of the Federal Wage System, which was enacted in 1972 under Public Law 92-392. This system provides that workers will be paid according to the prevailing rates in the local private sector. The country is divided into 134 local wage areas and surveys of private sector pay rates are made annually. These surveys produce reliable data. We are very confident in our determination of local prevailing rates.

Unfortunately, this system, which was enacted with strong bipartisan support and signed by a Republican president, has not been allowed to function as intended. For the past 17 years, Congress has imposed artificial "pay caps" on the Federal Wage System, limiting the amount of any pay increase, regardless of changes in the local prevailing rates. This has made federal blue collar pay lag behind the private sector in nearly every part of the country. As of the end of Fiscal Year 1995, the average pay gap was 6.52 percent, with some wage areas as much as 23.48 percent behind. The system that Congress created in 1972 is sound, and it should be allowed to work as intended. Pay caps have cost federal craft and trade employees tens of millions of dollars since 1978. Congress should end the politically motivated manipulation of the system and allow these workers to be paid in accordance with the local prevailing rates.

As in the private sector, employees are paid an overtime premium for hours worked in excess of 40 in a week. The Fair Labor Standards Act covers the federal sector workers and private sector workers alike. Federal craft and trade employees, unlike white collar workers, also are eligible for overtime premium pay for hours worked in excess of eight in a day.

In addition to basic salaries or hourly wages, it is a common compensation practice to pay employees differentials for working late shifts or on Sundays or holidays, and for exposure on the job to certain hazardous conditions. The Federal Wage System provides for the same differentials to be paid to covered employees, government-wide. Employees receive a seven-and-a-half percent differential when a majority of their shift occurs between 3:00 pm and midnight, and a ten percent differential when a majority of their shift occurs between 11:00 pm and 8:00 am. Work performed on a non-overtime basis on a Sunday receives a 25% differential. Work performed on a federal holiday is paid at double-time. Employees exposed to hazardous conditions which have not been practically eliminated receive differentials ranging from four percent to 100 percent depending on the severity of the hazard. These are in conformance with the commonly accepted private sector practice.

Another area of compensation that could be compared between the private and federal sectors is the way in which pay and benefit levels are established. Under the National Labor Relations Act, wages and fringe benefits are mandatory subjects of collective bargaining between a private sector employer and a union that holds exclusive recognition. In the federal sector, the right to bargain over compensation is denied to virtually all employees.[1] Almost 60% of the eligible federal workforce are represented by labor unions, compared to just ten percent in the private sector. AFGE believes that collective bargaining over compensation would serve the interests of the government as an employer, the federal employees and the taxpaying public.

Federal employees' pay should stop being the political football it has become over the years. Compensation levels are set according to some arbitrary figures that have nothing to do with market rates or the need for government to be able to attract and retain qualified workers. Federal managers should be trusted to negotiate fair and responsible contracts with unions that meet these interests.

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[1]Some employees of nonappropriated fund activities, and some craft and trade employees who were exempted from the provisions of PL 92-392 are permitted to negotiate over some aspects of compensation.

Conclusion

Federal compensation has suffered enormously over the past two decades, for reasons which were entirely unrelated to changes in private sector compensation practices. Salaries lag by as much as 27 percent, health benefits lag by $1,100 per worker per year with almost 18 percent of those eligible left uninsured. Retirement benefits have been cut time and again. The federal government's promises to federal employees have been continually broken.

AFGE has embraced change in the workplace, breaking new ground in labor management relations in order to reinvent the way the government does business. No union has been more willing to work toward the goals of improving efficiency and service delivery to the American public. But our efforts have earned us increased attacks on federal compensation. Enough is enough. Federal compensation as a whole lags behind prevailing private sector standards, and no reasonable case can be made to the contrary.

This concludes my testimony. I will be happy to respond to any questions.

Mr. MICA. Thank you, Mr. Sturdivant. I look forward to responding to some of your comments when we get into the questioning. Also, I would like to welcome back Mr. Wendell Cox. Mr. Cox is with the Wendell Cox Consultancy. Thank you.

Mr. COX. Thank you, Mr. Chairman. Thank you for the opportunity to testify in front of you today. I am principal of Wendell Cox Consultancy in Belleville, IL, and I'm principal author of the "America's Protected Class" series, which has been published by the American Legislative Exchange Council. I would ask that my written remarks be made a part of the record.

Mr. MICA. Without objection, so ordered.

Mr. COX. Thank you. I'm going to go at the subject, perhaps, from a bit different perspective than some of the others today. One, I will tell you right out—and I'll give you evidence of this—that it is my firm belief that Federal employees are overpaid, not underpaid. Second, that we need, I believe, in looking at Federal compensation issues, to begin with the top-down approach. That is, look at the total cost, rather than, as it were, a bottoms-up approach. We need to be aware of those costs.

Starting out from a basic position that only the market can determine market compensation, and any time you attempt to determine market compensation through administrative mechanisms, it is going to be rough, at best.

I would suggest, in the case of the Federal system, which excludes consciously major elements of compensation, it misses by a long shot. Indeed, it was the failure and the inability of Soviet planners to set market prices that caused the fall of that economy.

We've all heard about the OPM studies that suggest that Federal civilian employees are paid to 20 to 25 to even 30 percent below their compatriots in the private sector doing similar work. I don't think that's true. I think most of the academic studies indicate that Federal wages are, in fact, above, not below, private wages for comparable work.

But I would suggest, even beyond that, we need to recognize that the OPM system deals even with wages. It does not deal with benefits. It does not deal with retirement issues and that only about 75 percent of the cost of total Federal compensation is in wages.

I spoke to you before in April and described to you research in which we concluded that the value of Federal employment was about 50 percent, dollar for dollar, above that of private employment, if you assumed equal starting pay, and that, even if you accepted the OPM estimate of about 22 percent below on the part of Federal employees, you would still have a Federal employee premium at the end of a 40-year career.

I would argue that the Federal pay system is flawed. It does not include major elements of compensation, and one of the major difficulties with the Federal pay determination system is it does not check itself against the market. For evidence of that, I would suggest to you that in the Federal civil service, where the average tenure is 15 years, is three times that of the private sector and more than three times that of the private sector, adjusted for the composition of the Federal work force.

Now, oftentimes, when we compare public and private compensation, we hear advocates who suggest, well, you've got to compare the compensation of the composition of the work force, that the Federal work force has a much higher percentage of white collar employment, and, therefore, we should conclude that it's justifiable to pay them higher salaries and higher benefits.

Well, I would suggest some caution with respect to that, because the fact is that half of the white collar employment in the Federal service is clerical. In the private sector, clerical workers are paid less; they are compensated less than average.

I don't argue that some adjustment should be made for the compensation of the Federal work force. I only argue that it is nowhere near sufficient to make up for the difference that we see in the Federal compensation, relative to the private work force.

But my most important message to you today has to do with benefits. Something has happened with respect to Federal employee benefits in the last 13 years that I'm not sure you're aware has occurred.

According to National Income and Product Account data, in 1980, the average private sector employee had fringe benefits above wages and salaries of 18.5 percent. The average Federal worker—that is Federal nonmilitary worker—had benefits of 18.6 percent—that is, employer-paid benefits.

By the year 1993, the private number had risen from 18.5 to 19.8; the Federal number had risen from 18.6 to 35.5. We have had an escalation in employer benefits in the Federal sector, over the last 13 years, 13 times that of the private sector.

What that means is that Federal employees, when you count the tax-free nature of the Federal benefits, have gained $9,000 in annual income relative to their private sector counterparts. What that says is, if the market had been operating with respect to benefits in the Federal sector, we would have spent in 1993, as a Federal Government, $18 billion less on Federal employee compensation than we did.

As a result of that escalation in Federal benefits, we have seen the gap between average private and average Federal non-military pay rise from 32 percent in 1980 to 53 percent in 1993.

In 1993, according to the National Income and Product Account data, the average Federal employee was paid $53,000 in total wages and benefits, the average private sector employee, $35,000. If you adjust that for the excess time off taken by Federal employees, the gap per hour worked moves to 62 percent. Now, this has happened, I believe, because we have a flawed system and because, frankly, nobody is looking very closely at the change in benefits.

I'm running out of time, so I want to just comment on a couple of other things. What about the effect on the private sector of the escalation of benefits above market in the Federal sector?

Well, if we take our $18 billion number and we adjust it for the dead weight tax loss, according to the research done by Dr. Jorgerson at Harvard, that suggests that, for every excess dollar of Federal taxation, there is a loss in the private market of $1.40 in economic growth. That means it has cost us—the GDP—about $25 billion.

Now, if you look at overall economic factors, what you will find is $25 billion creates about 425,000 private jobs, a very significant number. A 0.5 reduction in the unemployment rate could have occurred if the jobs had been created according to the overall rates in the economy.

In conclusion, there is substantial evidence that Federal employees are compensated above market. I would suggest three reforms. The first, we need to use the private market, the competitive market, through privatization, competitive contracting, vouchers, wherever possible, so that we can stop arguing about Federal employee compensation and let the market determine it.

Second, to the extent that we don't do that—and there will be a considerable extent that we don't do that—we need to include in Federal pay determination systems those elements that are excluded now, such as excess paid leave, excess benefits, the tax-free value of the excess benefits, the better increases, and, frankly, the security.

But, as the Concord Coalition has indicated in a recent report, job description comparisons, such as the Federal system, are notoriously unreliable, since Federal agencies, unlike most private employers, face strong incentives to inflate them. A better approach to the entire comparability question, a market test that weighs the total attractiveness of a job to everyone who might fill it, is to look at job turnover rates.

I would recommend, Mr. Chairman and the members of the committee, that the Federal system add another element, an element that would compare its results to turnover rates in the private sector and manage its work force to achieve market turnover rates and adjust wages and benefits downward until such point as that is achieved.

Mr. Chairman, I would suggest that only inside the Beltway does anybody truly believe that Federal employees are underpaid. Indeed, if one were to accept the OPM study that suggests that there's about a 22 percent wage gap, then one would have to, based upon the pay per hour at this point, conclude that Federal employees should be compensated at 210 percent of the private sector average. I do not believe, Mr. Chairman, that the average taxpayer believes that.

The Federal Government has a duty to exercise stewardship with respect to the public's money to ensure that it is not paying more than market for anything that it buys. I believe, Mr. Chairman, that the Federal pay determination systems must be reformed, that we must eliminate the waste of paying more than necessary. It's absolutely necessary for fairness to the taxpayers and for fairness to future generations that are saddled with the debt that we are creating for them. Thank you, Mr. Chairman, very much.

[The prepared statement of Mr. Cox follows:]

Statement of
Wendell Cox,
Principal,
Wendell Cox Consultancy

INTRODUCTION

My name is Wendell Cox. I am principal of Wendell Cox Consultancy in Belleville, Illinois and served for three years as Director of State Legislation and Policy for the American Legislative Exchange Council. I am also principal author of the *America's Protected Class* series (co-authored with Samuel A. Brunelli), which documents the comparative advantages of public employment in the United States. Thank you for the opportunity to share our research and views with you.

In his letter of invitation, Chairman Mica asked that I deal with a number of issues. Most of my testimony will relate to the first general issue: comparison of public and private sector compensation and benefits.

1. COMPARING PUBLIC AND PRIVATE SECTOR COMPENSATION AND BENEFITS

Market rate compensation can only be determined by the market. Market prices, including the price of labor, cannot be reliably determined through administrative processes. Nobel Laureate Frederik Hayek cautioned that the competitive price cannot be known until there is competition. Indeed, the inability of Soviet planners to reliably establish market prices — even after 70 years — produced gross economic misallocation that contributed heavily to the collapse of that economy.

Even so, administrative methods for estimating market compensation will be even less reliable if they fail to account for readily quantifiable elements of value. This is the case of the federal government, which bases its non-military employee compensation determination entirely on wages and salaries, and excludes other significant elements of compensation such as employer paid benefits and paid time off, and superior job security. (Federal non-military employees include federal civilian employees and federal government enterprise employees [primarily US Postal Service employees].)

There is more to employee compensation than wages and salaries. The federal Office of Personnel Management (OPM) has estimated that, on average, federal civilian wages and salaries are 22.3 percent below that of comparable private employees — this is referred to as a "pay gap." But wages and salaries represent less than 75 percent of federal non-military employee compensation. Moreover, academic studies often find federal pay premiums rather than a pay gap.

There is considerable inherent excess value in federal employment. I reviewed our research before your subcommittee on April 5, 1995. This was published by the American Legislative Exchange Council under the title *America's Protected Class: The Excess Value of Public Employment*. The research developed an "excess value factor," which when applied to assumed level of federal wage and salary comparability would provide a reasonable estimate of the total compensation value for federal non-military employees compared to that of comparable private employees.

Using a hypothetical case, we estimated the extent to which inherent differences between private and federal non-military employment impacted the value of total compensation (wages and employer paid benefits adjusted for hours worked). The elements analyzed included employer paid benefits; paid holidays, vacation days, and sick days; the federal income tax free value of the higher employee benefits; larger annual compensation increases; and the relative value of job security over a 40 year employment career. The resulting excess value factor was 50.8 percent.

Our excess value estimate is consistent with previous research. A 1982 study estimated the extent to which federal employee wages and salaries would need to be reduced to achieve balance between the supply and the demand for federal jobs.[1] Applying federal employee composition-weighted relative compensation increases (1982 to 1991) to this study yields an excess value factor of 55.0 percent — somewhat above our original estimate of 50.8 percent.

Applying the original excess value factor of 50.8 percent, the following can be concluded:[2]

- If it is assumed that a federal employee's starting salary is 22.3 percent below that of a comparable private employee (based upon the President's Pay Agent "pay gap"), the value of the federal employee's compensation would exceed that of the private employee by $261,000 over a career.

- If it is assumed that a federal employee starting salary is equal to that of a comparable private employee, the value of the federal employee's compensation would exceed that of a comparable private employee by $586,000 over a career.

- If it is assumed that a federal employee starting salary is 11 percent above that of a comparable private employee (Based upon research by Krueger[3]), the value of the federal employee's compensation would exceed that of a the private employee by $777,000 over a career.

Only if it is assumed that a federal employee's starting salary is 33.7 percent or more below

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[1] Steven F. Venti, "Wages in the Federal and Private Sectors," David A. Wise, editor, *Public Sector Payrolls*, University of Chicago Press (Chicago, IL: 1987).

[2] The first case uses federal non-military wages and salaries as the equal base for both sectors. The second and third cases use private wages and salaries as the base for both sectors.

[3] Alan B. Krueger, "Are Public Sector Workers Paid More than their Alternative Wage? Evidence from Longitudinal Data and Job Queues," Richard B. Freeman and Casey Ichniowski, *When Public Sector Workers Unionize* (Chicago: University of Chicago Press: 1988).

that of a comparable private employee would there be no excess value for the federal employee. And, if federal employee compensation were truly below market rates, the federal government would, frankly, be unable to retain its employees. This is not the case.

Federal pay determination mechanisms yield untenable results. If federal pay systems were reliable — that is, if they produced results consistent with labor market outcomes, then average employee tenure (period of employment with the current employer) among federal non-military employees would be similar to that of comparable employees in the private sector. The federal government would not be able to retain its employees. But the opposite is the case. Average federal employee tenure has been estimated at three times that of private employees. This is a strong indicator that federal non-military employee compensation is well above market rates.

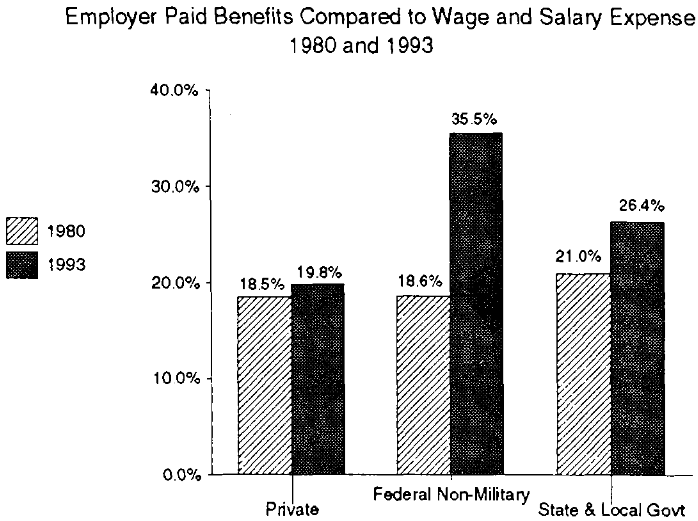
Whenever contrasts between federal employment are highlighted, objections are raised that there are significant differences between the two sectors — that there is a higher concentration of white collar employment in the federal government than in the private sector. But a higher white collar work force composition does not necessarily justify substantially higher federal compensation. One category of white collar employment, administrative support and clerical workers, is paid less than in the market than the private sector average. Approximately half of federal non-military white collar employment consists of administrative support and clerical workers.

Differences in the composition of federal non-military employment relative to private employment are not sufficient to account for the much higher compensation received by federal employees. Average employee tenure is an indicator of the value of particular types of employment to employees. The composition of the federal work force justifies a difference in average tenure of not more than 10 percent — a small fraction of the actual difference.

Federal employee benefit costs are excessively high and have escalated unreasonably. It is important to consider not only the design of federal employee benefits from the "bottom up," but also the overall impacts of any package of benefits from the "top down." Most of the testimony you hear is likely to be "micro" in its approach, while mine will be "macro" ("top-down").

The average cost of federal employee benefits — as a percentage compared to wage and salary expense — is nearly double that of private employees. Yet the composition of the federal work force justifies only a small differential from the private sector average.

Federal employee benefits were not always so far out of reconciliation with the market. Indeed, in 1980, federal employee benefits were similar to the private sector average. Since that time, federal employee benefits have increased by 105 percent — 13 times that of the average private employee (Chart). The federal employee increase has been 3.5 times that of state and local government employees. No conceivable work force composition could justify this extent of federal advantage.



Source: National Income and Product Accounts

If employer paid benefits for federal non-military employees had reflected the changes in the market from 1980 to 1993, the taxpayers and consumers of government enterprise services would have paid $18 billion less in 1993. The above market escalation in employer paid benefits widened the average federal non-military employee's compensation advantage over that of the average private employee by $6,400 — $9,000 in tax free equivalent income.

Federal employment is more lucrative than private employment. The result is that average federal employee compensation increased 22.5 percent from 1980 to 1993, more than 3.5 times the private sector average of 6.1 percent. Federal non-military compensation increased 268.9 percent relative to private employee compensation over the period. The federal increase is more than double the rate justified by the composition of federal employment.

In 1993, total compensation — wages and paid benefits — were 53 percent more than average private compensation, an increase from the 1980 differential of 32.2 percent. The federal non-military compensation advantage over the average private employee increased from $10,500 in 1980 to $18,200 in 1993. The 1993 differential is approximately four times the level justified by the federal work force composition.

CHANGE IN AVERAGE ANNUAL EMPLOYEE COMPENSATION: 1980 TO 1993				
	1980	1993	Change	%
Private Employees				
Wages & Salaries	$27,557	$28,907	$1,349	+4.9%
Employer Paid Benefits	$5,093	$5,721	$627	+12.3%
Total	$32,651	$34,627	$1,977	+6.1%
State & Local Government Employees				
Wages & Salaries	$26,492	$30,039	$3,547	+13.4%
Employer Paid Benefits	$5,559	$7,931	$2,373	+42.7%
Total	$32,050	$37,970	$5,920	+18.5%
Federal Non-Military Employees				
Wages & Salaries	$36,406	$39,024	$2,617	+7.2%
Employer Paid Benefits	$6,759	$13,868	$7,110	+105.2%
Total	$43,165	$52,892	$9,727	+22.5%
Compared to Private	+32.2%	+52.7%	+392.0%	+268.9%
Inflation Adjusted (1993$) Full time equivalent employees *Calculated from National Income & Product Account data*				

But there's more. Federal employees are granted paid leave of at least 10 days more annually than can be justified by the federal work force composition. When applied to the 53 percent differential above, the federal compensation advantage becomes 62 percent.

Then there is the nearly $1 trillion in unfunded federal civilian pension liabilities. These are payroll expenses that do not show up in federal compensation figures but which must be paid. OPM estimates that a 40 year amortization of unfunded federal civilian pension would add another 20 percent to federal compensation costs relative to wages and salaries.

There are other advantages of federal employment. For example:

- Virtually all federal employees are eligible for severance pay compared to less than 40 percent of private sector "white collar" workers.

- In the 40 states with income taxes -- which comprise more than 80 percent of the population — the excess employer paid benefits represent a further tax free value to federal employees.

- In states comprising more than 25 percent of the population, federal (and state) employee pensions are exempt from state income taxes unlike private pensions.

- Federal employee pensions are of the more lucrative "defined benefit" type and provide annual cost of living increases. Private employees are much less likely to be covered by pensions. Further, private pensions are more typically of the less lucrative "defined contribution" type and generally do no provide cost of living increases.

The causes: deficient pay determination methods and failure to apply administrative tests of results against the market. Why is the federal non-military compensation system producing results that are so at odds with the market? Obviously, as has been noted above, a major contributing factor has been the design deficiencies of the federal pay determination systems. But there is another factor — that the federal pay determination system results are not modified to reflect actual labor market outcomes. It is not enough to categorize jobs as comparable in the federal and private sectors. Job categorization is a difficult and subjective process. If the comparability determination process is reliable, then labor market outcomes will be similar -- average turnover rates will be similar. If the comparability determination process is unreliable, then there will be substantial differences in turnover rates between the two sectors. And, as noted above, that is the case -- average federal employee tenure is substantially greater than that of the private sector even after adjusting for the federal work force composition. This huge difference indicates that the value of federal jobs is well above the market.

The federal government is not subject to the competitive market. It does not have to compete for revenues against other entities offering the same products to consumers. It cannot be challenged by new entrants, nor does it face liquidation as a penalty for failure in the market. Unlike firms in the competitive market, the federal government can afford to pay above market employee compensation, because it can compel taxpayers to pay, unlike private entities. The public is paying more than necessary for federal non-military employee compensation.

2. Effect of Excess Federal Benefits on the Private Sector

As was indicated above, federal employer paid benefits are considerably higher than employee benefits in the market. The excess amount taken from the private sector has impacted the private sector and probably by more than the direct amount taken (which is estimated at $18 billion for 1993). Research has indicated that each excess dollar in federal taxation destroys economic growth in the amount of $1.39[4] — this is referred to as a "deadweight tax loss" or "excess burden of taxation." Based upon this finding, the excess burden of taxation related to excess federal employee benefits would be $25 billion annually. Based upon overall economic factors, this could translate into a loss of 425,000 private sector jobs, which would have otherwise been created (and which would have reduced the unemployment rate by 0.5 percentage points).

3. Tax Treatment of Employee Benefits

Any time government intervenes in the market, there will be misallocation of resources. It is for this reason that government intervention should be kept to a minimum. For example, government intervention in the employee compensation market was a major contributor to misallocation in health care markets. Health care arose as an employee benefit as employers and employees sought to increase employee compensation without violating federal wage and price controls in the 1940s. Many experts believe that the escalation in health care expenditures is a direct result of separating the responsibility for payment from the health care recipient. As Nobel Laureate Milton Friedman noted, *people are more careful with their own money than with other people's money*. From an economic perspective, it would be best to treat all employee compensation as taxable income. And, of course, there should be no difference with respect to the treatment of benefits or taxation of benefits between the public and private sectors.

Federal Pay Determination Must be Reformed

The evidence is overwhelming. Federal non-military employee compensation is above market rates — it is higher than necessary. The differences in the composition of federal non-miliary employment relative to private employment are not sufficient to account for the much higher compensation received by federal employees.

Administrative pay determination mechanisms are inherently flawed. But these flaws do not justify a federal system that is neither complete in the elements it considers nor credible in the results that it produces. The federal pay determination systems need to be reformed. The following principles should be followed.

- Wherever possible, employee compensation should be determined directly by the market. Federal services and programs should be converted to market mechanisms such as competitive contracting and privatization to the greatest extent feasible.

- Where federal employee compensation is determined administratively, the

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[4] Dale W. Jorgerson and Kun-Young Kun. "The Excess Burden of Taxation in the United States," *Journal of Accounting, Auditing and Finance*, September 1990.

methodology should include all quantifiable elements of compensation. At a minimum this should include wages and salaries, employer paid benefits, the tax free value of excess employer paid benefits (including the fully funded value of employer pension contributions), the value of excess paid leave, and relative compensation increases.

- *But,* as a Concord Coalition report puts it, *job description comparisons are notoriously unreliable, since federal agencies (unlike most private employers) face strong incentives to inflate them. A better approach to the entire comparability question — a market test that weighs the total attractiveness of a job to everyone who might fill it — is to look at job turnover rates.*[5] Routine and comprehensive reference checks should be established to ensure that federal non-military labor outcomes balance with labor market outcomes. Administratively determined compensation should be adjusted (generally downward) to achieve turnover rate parity with that of comparable private positions.

And, it must be recognized that even if these reforms were implemented, employment in federal functions not competitively contracted or otherwise privatized would still be determined by inherently flawed administrative mechanisms. ***The market rate can only be established by the market.***

Academic research routinely produces estimates of federal pay comparability that imply considerable underestimation by federal systems. It is safe to say that a large portion of the public perceives that federal employees are comparatively well paid. Only "inside the beltway" is there an broadly held view that federal employees are underpaid.

Government has a responsibility to exercise stewardship over the funds that it compels from taxpayers — a moral duty to spend no more than necessary to produce the services it has determined are necessary. The federal government appears to be failing in this duty with respect to employee compensation.

It is imperative that federal pay determination systems be reformed to eliminate wasteful excess spending for federal employee compensation. Fairness to taxpayers requires reform. And reform is required for fairness to future generations, who are already obligated by the burdensome federal debt.

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[5] Neil Howe and Richard Jackson, *The Facts About Federal Pensions* (Washington: The Concord Coalition: May 1995).

INTRODUCTION

I am submitting supplemental testimony (Supplement I) with respect to the General Accounting Office's analysis of *America's Protected Class: The Excess Value of Public Employment*. This issue was briefly discussed in your hearing on October 31, 1995.

On April 5, 1995 I testified before your subcommittee on the research findings of *America's Protected Class: The Excess Value of Public Employment* (co-authored by Samuel A. Brunelli and published by the American Legislative Exchange Council). The research developed an "excess value factor," which when applied to assumed level of federal wage and salary comparability would provide a reasonable estimate of the total compensation value for federal non-military employees compared to that of comparable private employees. Valuing such federal advantages as excess paid leave, higher employer paid benefits, the tax free value of higher fringe benefits, higher annual compensation increases and the value of superior security, we estimated an inherent excess value to federal employment of 50.8 percent. Thus, if it is assumed that comparable federal and private employees start with the same salary, the federal employee can be expected to receive $586,000 more in value than the private employee over a 40 year career.

In response to my Congressional testimony, Congressman James F. Moran asked the General Accounting Office (GAO) review our research. GAO has now released its letter and our response to the GAO's analysis (which we were able to review in draft). ***GAO dismissed our response out of hand, despite the fact that we directly refuted the most important points in the GAO analysis.***

THE GAO ANALYSIS

The GAO analysis includes constructive criticisms. But, in sum, ***incorporation of the recommendations would produce little difference from our original estimate that federal non-military employment has an inherent excess value of 50.8 percent.*** As indicated in our GAO published response, a downward adjustment of 2.6 percent would be required.

GAO's analysis in no way diminishes the public policy significance of our research --- that federal pay determination excludes factors that add considerably to the value of federal employment. ***If the excess value were one-half or even one-quarter of the 50.8 percent estimate, there would still be considerable imperative for reform.***

This supplemental testimony provides point by point comments on the GAO report, which could not be accommodated in the space available for our formal response. In short, much of the GAO report represents questionable criticism, which will be outlined in this testimony:

- ***GAO's analysis is not balanced*** in that it considers only factors that would reduce our excess value estimate. A balanced approach would have required consideration of factors that would increase the excess value estimate.

- Some of GAO's criticisms are ***immaterial.***

- Some of GAO's findings are ***simply erroneous.***

Worse, however, in some respects GAO analyzes a report we did not produce, rather than the one we presented:

- GAO devised objectives for our research which we did not intend, which is inherently unfair.

- GAO attributed to us conclusions and assumptions that we did not make.

On balance the GAO analysis falls short of the objective standard that is the right of Congress and the American people to expect.

THE GAO ANALYSIS AND OUR RESPONSES

GAO EVALUATION QUESTION #1:
Does the Methodology Provide a Reasonable Basis for Comparing Equivalent Positions Across Private and Federal Sectors?

RESPONSE:
Yes, to the extent that we sought to produce such a comparison.

See discussion below.

GAO POINT:
No Clear Basis for Comparing Similar Employees Is Provided.

RESPONSE:
Our comparison was a "macro" level comparison. The GAO evaluation unfairly applied a "micro" level standard.

GAO indicated that our methodology should have either matched comparable positions in the two sectors or made the case that the two sectors have an equivalent mix of positions. The following discussion outlines the erroneousness of these criticisms.

Our intention was not to compare equivalent positions across the two sectors at the "micro" level. It was rather to quantify inherent differences in value (an excess value factor, which would be expressed as a percentage) that could be applied to any general assumption with respect to the relative wages of comparable private and federal employees at the "macro" level. There is considerable debate about the level of federal employee wages and salaries compared to those of comparable employees in the private sector. The official federal estimate (the "President's Pay Agent" estimate) is that federal employees are paid 22.3 percent less in wages and salaries than their private counterparts. In contrast, ***most non-governmental studies suggest the opposite*** --- that federal employees are paid higher wages and salaries than their private sector counterparts.

The significance of the excess value factor is this: With respect to any assumption of average differential between the wages and salaries of federal and comparable private sector employees, there is an additional value of 50.8 percent to federal employment (the excess value factor is applied to the federal compensation package).

A broad statement estimating the average differential between federal and private employee compensation ***is not inherently invalid.*** Indeed, ***the President's Pay Agent has produced such an estimate*** --- that the average federal employee is underpaid by 22.3 percent. The President's Pay Agent estimate is the result of a "bottom-up" analysis of job descriptions and wage and salary comparisons (a process that we and others consider seriously flawed). Our excess value estimate is based upon a "top-down" approach which attempts to estimate the differences in the value of employee compensation using broad labor market factors. Our approach, frankly, is superior for two reasons:

- The excess value approach attempts to quantify more factors of value and is therefore ***more complete.***

- A "bottom-up" approach is prone to erroneous results at the "macro" level (because its accuracy depends upon perfection in analysis of the numerous federal and private jobs). The results of any "bottom-up" approach ***must be calibrated against overall labor market factors*** (the estimation of which requires a "top-down" approach). One overall labor market factor suggests that the President's Pay Agent estimate is grossly inaccurate --- that average employee tenure in the federal sector is considerably longer than for a comparable private work force composition. If federal employee compensation were less than that of comparable private employees, average tenure rates would be considerably less than in the private sector.

There is no question but that our approach would require further research for use in federal compensation determination on a job by job basis. It is likely that only the federal government has the financial resources necessary to perform this task, and my October 31 testimony offers recommendations for improving the federal pay determination systems.

The federal and private sectors do not have an equivalent mix of positions. However, ***the differing work force composition accounts for little difference*** with respect to fringe benefits, paid leave, average annual compensation increase, and average employee tenure. Our approach is thus valid. This is largely because the higher percentage of "white collar" jobs in the federal sector includes contains relatively equal distributions of workers who are higher paid and workers who are lower paid (clerical workers) in the private sector (see below).

GAO POINT:
Contrary Evidence about Comparability of Positions Not Addressed

RESPONSE:
The "contrary" evidence is of far less significance than GAO implies.

GAO notes differences in the composition of the federal and private work forces might be responsible for differences in compensation between the two sectors, largely because the federal sector has a higher percentage of "white collar" workers. But ***not all white collar occupations exhibit higher than average compensation.*** A large percentage of federal white collar employment is administrative support and clerical employees, who account for twice the share of federal non-military employment as private sector employment. In the market, compensation for administrative support and clerical employees is less than the private sector average. Differences in the composition of federal non-miliary employment relative to private employment are not sufficient to account for the much higher compensation received by federal employees. Our future reports will deal with this issue in greater detail.

GAO EVALUATION QUESTION #2:
Does the Methodology Represent a Balanced Approach to Measuring Both the Compensation Advantages and Disadvantages of Federal Employment?

RESPONSE:
The methodology is balanced.

See discussion below.

GAO POINT:
Areas of Possible Private Sector Advantage not Addressed.

RESPONSE:
GAO is wrong. Each of the elements addressed was potentially an area of possible private sector advantage.

In the case of each area considered, we evaluated the extent to which the element might be a private or federal advantage. In each of the cases we identified there was an overall public advantage. GAO identified one element that we did not study, and which conveys private advantage in relation to federal employment: the tax free value of Social Security income. Federal employees on the Civil Service Retirement System are not covered by Social Security and, therefore, do not receive this benefit. ***Inclusion of this private sector advantage would have reduced our 50.8 percent excess value factor by a small amount*** --- less than 0.5 percentage points. We will include this factor in future analyses.

GAO POINT:
Approach to Valuing Factors Requires Justification

RESPONSE:
This is unfair. These GAO comments evaluate our work based upon its objectives, not ours.

GAO's lengthy analysis of this issue misses the point. Our purpose was to estimate the value of employer payments made on behalf of employees over a career. Based upon this objective, our valuing of each factor was consistent and appropriate. GAO's analysis is based upon objectives that we did not seek to achieve.

One GAO comment deserves special attention: "If the value to the federal employer is equal to the value to the employee, then one would not interpret this situation as one of excess value." This is patently incorrect. ***Market value can only be established in the market.*** Federal employee compensation is established outside the market. A non-market employer has no mechanism for determining market value, and this is especially true with respect to the federal government, which compels its revenues from the public (through taxes, borrowing, or monopoly prices). Where employee compensation exceeds market rates, then there is excess value. On average, federal employee compensation is above market rates, and excess value is thus present.

GAO EVALUATION QUESTION #3:
Is the Assumption of Equal Starting Salaries for the Federal and Private Sectors Reasonable?

RESPONSE:
This criticism is unfair. We provided a number of assumptions with respect to starting salaries, all within the range of published studies.

GAO has misrepresented our research with respect to this issue. Federal and private salaries were assumed to be equal only for the purpose of calibrating our model. Specific examples of excess value calculations are provided for an array of starting salary assumptions (private higher than federal, equal, and federal higher than private), and are illustrated in charts in the Appendix to this testimony. Our low assumption used the President's Pay Agent's estimate of a 22.3 percent federal pay gap. Our high estimate used a report that found a 3.1 percent federal pay premium. Other reports have found as much as a 17 percent federal pay premium. Any assumption within this wide range of federal-private salary disparity would have been reasonable

GAO EVALUATION QUESTION #4:
Is the Available Evidence Sufficiently Compelling to Assert Advantages to Federal Employment in Areas Where Sector Comparisons are not Quantified?

RESPONSE:
GAO has unfairly attributed to us and evaluated a conclusion that we did not make.

We cited 12 additional factors that are generally advantages of public employment, but which are not easily quantified. These factors were not analyzed in detail, in that they were not critical to our excess value analysis. Yet GAO devoted considerably more space to their analysis of this secondary issue than any of the other three.

GAO made a fundamental logical error with respect to this section of our report. ***Our conclusion is that the 12 factors, in the aggregate, produce a net advantage for public employees in relation to private employees.*** GAO analyzes this section as if we contended that all 12 factors produce a federal advantage. ***We did not.*** As a result, ***GAO's analysis of this section is largely irrelevant.*** Nonetheless, some further comments are appropriate.

GAO POINT:
Comparisons Should Be Based upon Data from Both Sectors.

RESPONSE:
Our comparisons <u>are</u> based upon data from both sectors.

GAO's criticism is simply wrong. Virtually every factor listed was selected based upon an analysis of information from both the public and private sectors. GAO implies that we should have analyzed each of the 12 factors in much greater detail. ***This was not our intention.***

GAO's two cited examples do not survive scrutiny:

- ***GAO's criticism with respect to productivity is both irrelevant and wrong.*** It is irrelevant because the Reinventing Government initiative (which we used to estimate the potential for productivity improvement) ***is improving federal government productivity.*** It is wrong because ***we did consider data from the private sector*** --- the evidence with respect to productivity improvement through the use of private service providers (privatization).

- ***GAO's criticism of our severance pay discussion is also incorrect.*** Our claim is that some governments provide generous severance pay. The term "generous" is used to compare public severance pay with private. ***Generous severance pay is indisputably a federal advantage in that it is available to virtually all federal employees, but is available to less than one third of private employees.***

GAO POINT:
Federal Employees' Compensation Cannot be Assumed to Be the Same as State and Local Government Employees.

RESPONSE:
We did not assume that federal employee compensation to be the same as state and local government employees.

This assumption is supplied by GAO. It is not to be found in our paper. By listing unquantified advantages of public employment, we did not imply that all were advantages of all federal employment, nor did we generally imply that compensation factors were the same between the federal and state-local sectors. We did assume that federal and state-local sick day usage was the same, but we have since obtained data indicating that federal sick day usage is above that of state and local government employees. ***GAO's analysis lacks even-handedness in failing to cite this factor that would have increased the excess value estimate with respect to federal employment.***

GAO exaggerates by indicating that "several other" factors may result in private instead of federal advantage. In general usage, "several" denotes more than two but less than many. ***GAO cites only two examples.*** And, only one of these could actually be a federal advantage (total work hours). With respect to the other, GAO indicates that comparison of paid personal leave to private sector practice could produce a private, rather than federal, advantage. But ***GAO's analysis is not balanced*** in that it fails to note that seven percent of federal paid leave is not included in paid holidays or vacations, which more than offsets any private employee use of both personal and other paid leave days. We made no representation that all of the cited factors convey federal advantage.

GAO POINT:
Other Considerations May Change the Perspective on Advantages

RESPONSE:
No point made by GAO switches the perspective from federal advantage to private advantage with respect to any area we reported as conveying federal advantage.

GAO indicates that consideration of Social Security leads to "less contrast" in a comparison of federal and private sector retirement benefits. GAO does not dispute federal advantage, only the extent of federal advantage. ***But GAO stretches unnecessarily to make the point.*** We did not seek to quantify the extent of public advantage, much less federal advantage. Moreover, in attempting to equate the Civil Service Retirement System with Social Security, GAO failed to note that Social Security benefits are reduced for recipients under 70 years of age whose employment level exceeds a threshold. In contrast, federal pension benefits continue regardless of outside income. ***GAO's criticisms are irrelevant and unfair.***

GAO'S CONCLUSION IS ERRONEOUS

GAO concludes that "In some areas that the authors cite as federal advantages, the available evidence suggests the opposite." ***This is simply wrong.*** ***In no case did we cite a factor as a federal advantage for which evidence suggests otherwise, and no such example is cited by GAO.***

Finally, in contrast with GAO"s conclusion, ***the fact that our excess value estimate captures the minimal size of the federal excess value is unquestionable*** (even though no such federal specific conclusion was stated in the paper). The $0.9 trillion federal civilian unfunded pension liability, which would require annual payments of 31 percent relative to federal wages and salaries to retire over 40 years far exceeds any conceivable private advantage with respect to the non-quantified factors. (Private pension under funding per employee is less than 0.5 percent of federal pension under-funding per employee.)

THE GAO REPORT IS UNBALANCED

GAO's criticism is not balanced, because it considers only issues that would reduce the excess value estimate. For example, GAO failed to note that we could have justifiably used a marginal rather than average income tax rate with respect to the tax free value of excess federal paid fringe benefits. GAO further failed to note that our general conclusion that the non-quantified factors would further increase the excess value estimate would have been far stronger if we had referenced the unfunded federal pension liability. Finally, GAO failed to point out that our use of private sector average compensation as a base, rather than the substantially higher federal non-military compensation skewed our dollar estimates of federal advantage downward. A balanced report would have considered both elements that would decrease and increase our excess value estimate.

THE GAO ANALYSIS IS IMMATERIAL TO OUR CONCLUSIONS

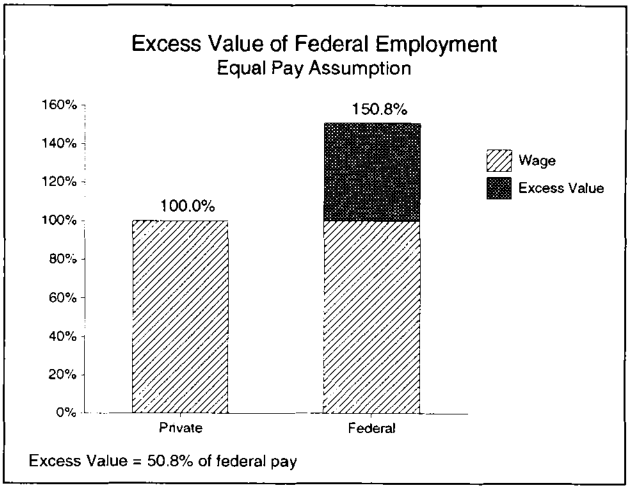
America's Protected Class: The Excess Value of Public Employment was not offered as the last word in valuing public employment --- it was rather meant to serve as a first attempt to value factors that are routinely excluded from analysis by the federal government and state and local governments. The facts remain:

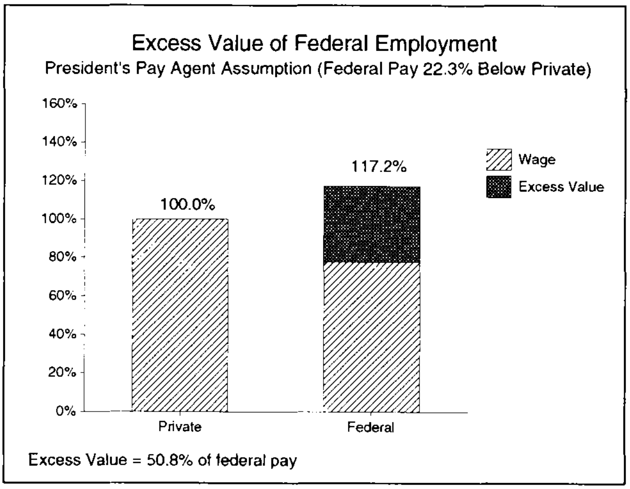
- The federal government determines non-military pay without quantifying the value of a number of factors of employee compensation.
- The value of the excluded factors is considerable.
- In the aggregate, the value of federal employment exceeds market value. Indisputable evidence of this is the far higher average tenure of federal employees relative to their private sector counterparts.

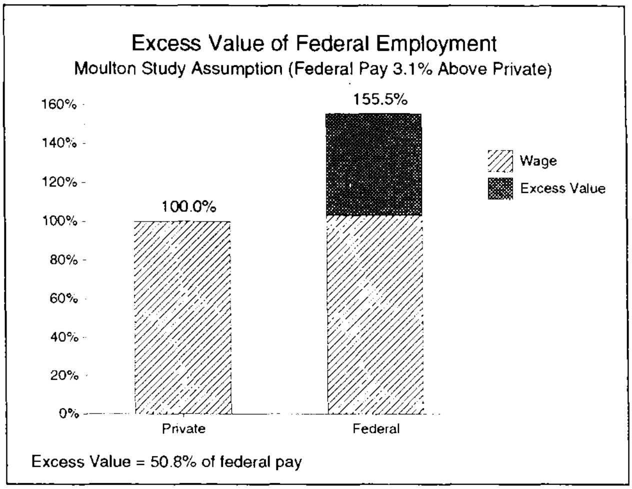
- In that the aggregate value is above market rates, it is of necessity true that the value of a great many federal jobs is above market rates.

Thank you for the opportunity to submit this testimony.

APPENDIX: CHARTS







Excess Value of Federal Employment
Moulton Study Assumption (Federal Pay 3.1% Above Private)
160%
140%
120%
100%
80%
60%
40%
20%
0%
100.0%
155.5%
Private
Federal
Wage
Excess Value
Excess Value = 50.8% of federal pay

I am submitting supplemental testimony (Supplement II) with respect to federal employee compensation.

There is a need to reform the Office of Personnel Management (OPM) employment reporting system so that Congress and the American people are provided a genuine picture of the cost of federal non-military employment. OPM's annual reports should be required to include all payments by all federal agencies on behalf of all federal employees or formal employees. For example, the 1993 Civil Service Retirement and Disability Fund Annual Report reflects $23 billion in federal payments to federal civilian employee retirement programs that are not included in the OPM annual report. Further, OPM's annual reports should reflect a reasonable value for unfunded pension liabilities for the year reported upon. Finally, OPM should be required to restate historical data to conform to these requirements.

Such "full disclosure" requirements would place on OPM and the federal government the same burden that federal regulatory agencies routinely require of commercial advertisers and others.

Thank you for the opportunity to submit this testimony.

Mr. MICA. Thank you, Mr. Cox. You've livened up an otherwise rather dull subcommittee hearing, with some pretty startling testimony, I might add.

How do we know that you're not comparing apples and oranges? You gave some statistics about private sector versus public sector benefits and I guess you started out 18.5, 18.6, 1980. What were you factoring into that to make your comparison? And then, did you use the same criteria when you got to—was it 1993 that you used?

Mr. COX. Yes, sir. What I indicated—this is out of the National Income and Product Accounts—OK? The 1980 data and the 1993 data are out of that. Now, I would argue that what I indicated, I didn't give you the whole story. The whole story is even worse, because, you see, there is this perception that the white-collar work force gets a higher benefit load than the non-white-collar work force. That's not true.

The fact is, if you look at the data, you'll find in the private market that, on a percentage basis, fringe benefits are higher in relation to total wages than in the white-collar sector, and so, as a matter of fact, the straight comparison of Federal versus private—which is what I have given you—actually should have been adjusted to reduce the Federal by about a percentage point, which would make it more of an apples-to-apples comparison. In other words, the percentage difference is bigger.

Mr. MICA. Your other comparison, which provided a startling contrast between public and private sector employment is the average wage. In your $35,000 figure versus $53,000, was your $53,000 all non-Defense positions? And then, what is your basis for comparison to reach the $35,000 figure for the private sector?

Mr. COX. OK. That, again, is Federal nonmilitary employment. That would include the Federal civilian sector, as well as government enterprises, the Post Office.

Mr. MICA. Right. And that would put you at $53,000?

Mr. COX. Now, that includes, however, wages and employer-paid benefits. That's not just the salaries. That's the salaries plus the benefits.

Now, I think if you look at the data, it is reasonable to assume that it would be acceptable for Federal employees to make more than average. If you look at the data, you could make an adjustment in the range somewhere of 10 to 15 percent, but you're not going to find anything to be able to justify anything like 53 percent, or 62 percent, if you adjust for the hours that they actually work.

Mr. MICA. You heard Mr. Sturdivant talk about some of the responsibilities that our public, Federal sector employees have—for example, cancer and AIDS research, and I think he said military research, and Social Security checks on time. He mentioned, as a fourth category, drugs entering into the country, which would be law enforcement.

Would you be countering by saying that all three of these functions could be privatized and that, in fact—there could be some savings by having the private sector perform these functions, as opposed to the public sector?

Mr. COX. Well, first of all, I would argue—and not to, in any way, take away from Federal employees who are involved in very important tasks—you also have private employees that are involved in those same important tasks.

No, I would not advocate, as the first step, for privatization, privatizing police functions, that kind of thing. That can be done. That should probably be the last thing that is done. I think that you should be looking at other functions before that. You should be looking at functions where there are private sector suppliers immediately available to do that kind of thing.

Mr. MICA. Mr. Sturdivant, you spoke about Xerox, IBM, AT&T, and the State of California. Maybe you could be more specific in some of the things they're doing that we are not doing in the Federal Government to reward employees as compensation incentives, somewhere where you would like to see us, where these companies possibly are.

Mr. STURDIVANT. Well, I think that when I was talking about some of the larger private sector companies, when we look at health insurance—and everybody's under a crunch in health insurance—but, certainly, the CRS compared the Federal Employee Health Benefits Plan with some of those companies and found that the Federal Government spent $1,100 less per employee than a private sector company of that size.

I think that, probably, if you're looking at some of the other things that some of these private sector companies are doing, they're some of the things that we've talked about to try to move toward rewarding people for productivity and efficiency.

Where we would be on that whole issue would be to—like dealing with this whole award system, where you have individual rewards now—and we would be looking toward some systems similar to, like, in a Saturn, where, basically, you have group awards. You have team awards; you build teamwork.

So I think that there are some innovative—I think that there are some innovative ideas in the private sector that we could look at. Certainly, having employees more involved, more participative in determining how the work is done, who does the work, and how do we move toward productivity and efficiency, I think a lot of that is going on in the private sector as they fight for market share and as they fight for profit. I think we can bring a lot of those practices, and certainly our union has insisted on trying to bring a lot of those practices to the Federal sector.

On this whole issue of privatization, one of the things—I'm glad Mr. Cox brought that up. No, that's right, Mr. Cox was on my side on that. That's the only thing he was on my side on, probably.

But you brought up privatization, and we just finished an extensive study on contracting out and privatization. We just finished an extensive revamping, so to speak, of the AFGE policy on contracting out and privatization. In fact, I think some members of your staff participated and attended some of those sessions.

We're prepared to take that issue on, if the playing field is level, if the factor is who can give the taxpayer the best bang for the buck. If we can get away from this stupid idea of FTE ceilings and determine who can do the best possible job, who can do it more effectively, who can do it more efficiently, and start from the same place, we are prepared to compete.

In fact, we want to compete. We say, bring it on, because, from what we've seen, 90 percent of the work that has been either contracted out or privatized, either Federal employees had to go back and redo it or it ended up costing the taxpayer more money.

Now, I don't know what—my executive council is in town, and I don't know what policy they're going to recommend that we adopt. But I will tell you that, if we can come to closure on the yardstick, and the yardstick being dollars and who can give the best possible bang for the buck for the taxpayer, notwithstanding politics, notwithstanding FTE ceiling, we will beat them 90 percent of the time, and we're prepared to do it.

Mr. MICA. We may be prepared to give you that opportunity. In the meantime, I will yield to our ranking member, Mr. Moran.

Mr. MORAN. Thank you, Mr. Chairman. Yeah, I think we ought to take John up on that challenge, as well. I think we really ought to pursue that. In fact, I would start with looking at Federal firefighter pay.

It turns out that when I was mayor 5 years ago, we were paying our firefighters almost 75 percent more than Federal firefighters received for the U.S. Government, and we didn't get one single complaint.

I'm amazed at how much less Federal firefighters get than municipal firefighters, and if you look at qualifications, people that perform whatever comparable functions there are in the private sector get paid comparable to municipal firefighters, not Federal firefighters.

But I want to talk to Mr. Cox here. In your calculation, Mr. Cox, did you take into consideration the fact that retirement pay for Federal employees is fully taxed, whereas Social Security is not?

Mr. COX. We've looked at that issue. That would get you about 0.5 percent. It would take our number from 50.8 percent to 50.3 percent. We did not look at that in our original study, but we have since looked at it.

Mr. MORAN. Well, I would like to see that, because it seems to me it would be considerably more. We've been getting into that issue, obviously, with regard to taxation in the reconciliation bill, and people that are dependent upon Federal retirement are paying considerably more, thus have considerably less take-home pay, if you will, or consumable income, because of the taxable nature.

I think we're going to run out of time, though, to get into a debate on some of these. One of the other issues, equivalent starting salaries, you know, I was working on Wall Street. I left, and I went to work for the Federal Government. I started at $5,000 a year; that shows you it was quite a while ago. I was a GS–5.

Mr. STURDIVANT. Must have had some great COLA's.

Mr. MORAN. No. You know, I did it because I understood that it was a learning and career track for me at the time, and I understood that there would be later compensation. But when I left the Federal Government and went into the private sector, I was making about $50,000, and, the next month, when I went into the private sector, I was making over $100,000 annually.

So my experience doesn't seem to comport with your analyses. My personal experiences, whatever assets I brought to the work force, they were certainly much better compensated in the private sector than they were in the Federal sector. That obviously doesn't appear.

But what I was most concerned about is the GAO study that identified five assumptions that you made. I'm sure you've read the study. All five of them do seem to raise some real question as to the validity of the results. Unfortunately, we've got to vote now, and then we've got a 5-minute vote right after that.

But I think we need to get at that, because if we're going to be using figures like this that seem to run in the face of all the other figures, all the other studies that we've had, we need to look at this and see where the differences are. The GAO says there are some substantial differences that really undermine the validity of your numbers.

How much time do we have here, John?

Mr. MICA. Two or 3 minutes.

Mr. MORAN. I see Connie—I think Connie wants to raise an issue, too.

Mrs. MORELLA. I cannot come back. If the gentleman could yield.

Mr. MORAN. Go ahead, Connie. I'll yield to you.

Mrs. MORELLA. I just got your report, the GAO report. I look forward to reading it, Mr. Moran, because I would be concerned, also, Mr. Cox, in terms of how you arrived at the benefits are better, the salary is better.

Mr. COX. If I might, before you leave, I have responded to the GAO report. You'll see our response there. You will see that the GAO failed to look at our response seriously. We, on point, answered every one of their criticisms and showed that their criticisms were not substantial, that they would make about a 2 percentage point difference.

Now, we were talking about a situation where we're estimating the value over a career of Federal employment equal employee pay, starting salaries, is about 50 percent of a premium for Federal employees. I am saying our number would drop to about 48 percent, based upon the GAO criticism. If it were to drop to 10, it should be still a matter of great concern.

Mrs. MORELLA. Incidentally, I'm also a co-sponsor of the Federal Firefighter Fairness Act, which I think is an excellent example that you pose on that. Maybe I could submit some questions, in terms of strategic planning, to Mr. Carter, and Mr. Sturdivant.

Mr. MICA. Yes. Since we have run out of time—they've just informed us we're going to have multiple votes—we will adjourn the hearing at this point. We will submit additional questions, and also have some informal discussions with all of you as we proceed.

We appreciate your testimony so much, Mr. Carter, Mr. Sturdivant, and Mr. Cox. You've lightened up and stirred up a Halloween eve, and we'll continue this. In the meantime, this subcommittee is adjourned.

[Whereupon, at 3:35 p.m., the subcommittee meeting was adjourned.]

[Additional information submitted for the hearing record follows:]

TESTIMONY OF
ROBERT M. TOBIAS
NATIONAL PRESIDENT

Chairman Mica, Members of the Subcommittee, I appreciate this opportunity to present testimony for your hearing today exploring the differences and similarities in private and federal sector compensation and benefit practices. The more than 150,000 federal employees represented by the National Treasury Employees Union welcome the opportunity for our views to be heard.

As we know only too well, there are some who seek to rewrite the "contract" that exists between the federal government and its employees, not only for those employees who may choose careers in federal service in the future, but for those who have committed their lives to public service as well as for those who have already completed their careers. Indeed, this Committee, as well as others in the House and Senate have received testimony this year from witnesses who unfortunately did not feel bound by the facts in presenting their views on federal compensation practices.

I think it's imperative to set the record straight on the most critical compensation issues surrounding federal employment -- pay, retirement and health benefits. This Union's goal, and I am sure your goal as well, is to insure that the federal government continues to be able to attract the best and the brightest to careers in federal service. Federal employee bashing by those who seek to discredit the federal workforce serve only to bring disdain upon our Nation. As issues become more complex, the federal government's mission becomes increasingly critical -- we simply must be able to attract the best individuals to serve our Nation.

However, as you may know, a 1994 General Accounting Office (GAO) Report entitled, "How Government Jobs Are Viewed On Some College Campuses" showed that little interest existed in pursuing a career with the federal government. The report indicated that low, non-competitive starting salaries and the poor image of government work helped fuel this decision. This was not the first study to arrive at such a disturbing conclusion.

A September, 1990 GAO Report (Recruitment and Retention: Inadequate Federal Pay Cited As Primary Problem By Agency Officials) also cited evidence that low federal pay was the most frequently stated reason for employees to leave federal government service, or to decline a federal job offer in the first place. At that time, the GAO warned that "recruitment and retention problems pose a major risk of reducing the quality of government services and programs." GAO went on to point out that "limitations on federal pay adjustments since the late 1970's have created a federal/private pay gap where average private sector salaries exceed federal salaries by about 25 percent."

By 1994, the Department of Labor was reporting that the average pay gap between comparable private and federal sector jobs stood at 27.5 percent. This was despite enactment of the Federal Employees Pay Comparability Act of 1990 (FEPCA) which mandated a mix of local and national raises to finally bring federal pay more into line with that received in the private sector and check the legitimate and well-founded fears of major recruitment and retention problems in the federal sector. As we know only too well, despite enactment of this landmark piece of legislation, federal employees continue to be compensated well below their private sector counterparts.

Had the pay law been allowed to function as written, federal employees would receive a 2.4 percent across the board pay adjustment in 1996 based on the Employment Cost Index (ECI). In addition, they would receive an average locality adjustment of 3.5 percent, based on Bureau of Labor Statistics (BLS) surveys of the differences between private and federal sector pay in 28 localities around the country. Instead, this Congress has mandated a woefully inadequate average 2.4 percent increase in federal salaries for the next fiscal year -- less than half of what is called for in the pay law, and less even than the rate of inflation which has been pegged as rising 2.6 percent over the last year.

We constantly ask federal workers to do more with less, and for less compensation -- we ask for more productivity with fewer workers, more effort, more supervisory responsibilities, more complex issues to be handled, yet we are not willing to compensate these hard working public servants for the work they do. If anything, this Congress has shown that its real interest is in continuing to take away from the federal employee pay and benefit package. Ultimately, it is the public who loses when the federal government is unable to recruit and retain the finest employees.

When FEPCA was adopted by a bipartisan group of House and Senate legislators and signed into law by President Bush, it was envisioned that by January, 1996, 40 percent of the gap between federal and private sector salaries would have been closed. We are nowhere close to that figure. FEPCA has been unable to remove politics from the process by which federal employees are paid, yet despite this, there are those who will come before this Congress and complain -- ignoring the facts -- that federal workers are overpaid in relation to their private sector counterparts.

As I just stated, federal workers are slated to receive an average 2.4 percent pay raise in 1996. A June, 1995 survey of 1,383 companies by the respected Towers and Perrin consulting firm showed that private company employee raises are at a six year low, averaging 3.6 percent. This is a six year <u>low</u> for these private companies. In 1995, federal workers only received an average 2.6 percent pay raise. Once again, private sector workers received considerably more.

Yet another 1995 survey completed by the consulting firm of

William M. Mercer, Inc., detailed chief executive salaries and found that pay for chief executives only rose by 11.4 percent last year. Only 11.4 percent. Federal workers -- regardless of their level of responsibility will only receive a 2.4 percent pay raise in 1996 and received only 2.6 percent the year before. This certainly seems to throw additional water on the preposterous notion that federal workers are overpaid in relation to private sector workers. I hope that those who would come before this Committee to assert the ridiculous notion that federal workers are overpaid would be asked by the Chairman to stick to the facts.

The same critics who assert that federal workers are overpaid are fond of adding to their rhetoric that federal employees have greater job security than private sector workers. While the number of Americans served by the federal government has grown tremendously in the last two decades, the number of federal employees has steadily declined. Federal employment has continued to drop since 1991 with the last Congress having written into law a further reduction of 272,000 federal jobs. This reduction will result in the lowest level of federal employment since John F. Kennedy was President.

Furthermore, Congress' inability to complete action on the Fiscal Year 1996 appropriations measures has created an unprecedented level of uncertainty for our Nation's public servants. As the beginning of the new Fiscal Year approached, federal workers grew increasingly apprehensive that they might be told to stay home from their jobs, that they might be unable to meet their mortgages, their car payments and their many other family obligations. Legislation preventing a federal government shutdown and widespread federal worker furloughs was passed by this Congress with only hours to spare before the October 1 deadline. And as this testimony is prepared, the date on which yet another federal shutdown could occur rapidly approaches. As November 13 draws near, federal employees are again concerned that they may soon be prevented from doing the jobs they have been hired to perform; that their obligations and responsibilities may be in jeopardy. This is no way to treat our dedicated federal workforce. Moreover, to hold federal workers out as having more job security than workers in the private sector is ludicrous and has no basis in fact.

According to the Bureau of Labor Statistics, the government employs one of every 90 Americans today. In 1946, that ratio was one in 62. The number of federal employees stood at 2.2 million in 1946. Today, not counting employees of the U. S. Postal Service, that number stands at just two million. During this same time period, the Nation's population rose from 140 million to 250 million. The facts speak for themselves.

Equally disturbing are the increasingly frequent attacks on the federal retirement system as overly generous and excessive relative to retirement benefits available to private sector employees. These statements represent little more than myths and are patently untrue, as has been borne out again and again by surveys and studies comparing federal and private sector retirement benefits.

A pension system is an important tool for an employer. It enables a company to attract and retain an experienced workforce as well as to encourage turnover among older workers and afford a younger, more diverse workforce the opportunity for upward mobility. The original Civil Service Retirement System (CSRS) as well as the newer Federal Employees Retirement System (FERS) were designed to meet these needs for the federal government. The federal retirement system was overhauled less than ten years ago and FERS was the result of that effort. Its adoption followed several years of analysis and review of private sector practice. It mirrored private sector practice in 1986 and it continues to mirror that practice today. Nonetheless, critics of the federal retirement programs continue to spread misconceptions and falsehoods concerning its generosity.

The Wyatt Company, an independent economic research firm, in its "Survey of Retiree Benefits Provided by Plans Covering Salaried Employees of 50 Large U. S. Companies" (January, 1993), indicates that the federal FERS system and the average private sector company provide almost identical pension benefits. This same study shows that 43 of the 50 surveyed companies offer their employees a defined benefit plan like the federal pension system where the employees' benefits are based on a formula that includes age, years of service and salary.

Furthermore, the BLS in its May 1993 report entitled, "Employee Benefits in Medium and Large Private Establishments..." states that common eligibility requirements for a normal, or unreduced, private pension are: age 65 with no specified length of service, age 62 with 10 years of service, and 30 years of service at any age -- the same practice followed in the federal retirement programs. Most private sector workers retire at age 62. According to the Office of Personnel Management, the average federal worker leaves government service at 61.5 years of age. As is common private sector practice, retirement from federal service is also possible at age 55, but only after 30 years of service.

BLS also points out that one area where federal and private pensions differ sharply is in the area of employee contributions. While federal workers participating in the CSRS contribute at least seven percent of their salaries toward their future retirement benefit, 97 percent of private sector pension programs require <u>no</u> employee contribution. Despite this fact and the goal stated by so many federal pension reformers that they seek only to bring the federal system more into line with private sector practice, this Congress has just voted to increase federal employee contributions toward their future retirement benefits. This is not a move that is at all consistent with a desire for uniformity with private sector pension plans. It is, in fact, based on little more than a desire to extract additional savings from the federal pension programs in the name of deficit reduction and serves to increase, not decrease the differences between public and private sector pension plans.

In a June, 1995 study comparing federal and private sector retirement benefits, the Congressional Research Service (CRS) points out that because federal workers covered by the CSRS program are required to make retirement contributions that the majority of their private sector counterparts are not, CSRS is less generous for the typical federal employee, following a typical career path, than retirement plans provided in the private sector. (Federal Civil Service Retirement: Comparing the Generosity of Federal and Private-Sector Retirement Systems, June 5, 1995) Despite the actions just taken by this Congress, this study shows beyond a shadow of a doubt that federal workers are already being asked to contribute too much toward their future pensions, not too little as some in this body might suggest.

Although the CRS study finds that the newer FERS retirement system can be said to provide somewhat more generous retirement benefits than the private sector plans to which it was compared, the relative generosity vanishes upon closer examination. FERS is an immature system and drawing comparisons between future benefits it might pay and a similar private sector plan requires assumptions concerning federal pay. For purposes of their report, "It was assumed that the employee would have the same promotion pattern as today's retiree and that Federal salaries would grow at the same rate as average wages in the economy." This assumption is optimistic at best. Given the fact that federal pay increases have not even kept pace with inflation, let alone the rate of wage increases in the economy, conclusions concerning FERS relative generosity cannot be factually established. Federal workers will receive a lower pay raise in 1996 than their private sector counterparts, they received less in 1995 and there is no reason to think they will receive more, or even a comparable amount in 1997.

Contrary to popular misconceptions, the average CSRS retiree is not getting rich off the federal government. The average retiree will leave the government after 30 years of dedicated public service with an annual pension of $18,444. Many of the federal employees represented by this Union will retire with far less. I submit that this is not a vast sum of money for the federal government's highly educated workforce. Nearly 40 percent of federal civilian workers have at least a Bachelors Degree compared to an estimated 20 percent of the population at large. Moreover, unlike private sector pensions, CSRS pensions are in lieu of, not in addition to Social Security benefits. Most CSRS retirees will never be eligible for Social Security benefits upon retirement.

In addition, every dollar of federal pensions is taxable while most Social Security payments remain exempt from federal taxation. In 1990, the nonpartisan Congressional Budget Office (CBO) reported that 20 percent of the earned annuities of federal civilian retirees went to federal income taxes. Thus, in real terms, because of the tax preference of Social Security benefits, federal retirees receive less retirement income than private sector retirees with comparable incomes.

There are several other critical penalties imposed on federal workers as a result of their having chosen careers in federal service that are rarely mentioned by those who seek to detract from federal service. The Government Pension Offset (GPO), for example, reduces, and often eliminates spousal Social Security benefits to which a federal retiree might be entitled. Under this offset, two-thirds of the amount of a federal retirement annuity is used to offset any Social Security benefit based on a spouse's work record that the federal retiree might be expecting. Federal retirees are denied this benefit simply because they chose careers in federal service.

Yet another offset, the Windfall Reduction Formula, reduces a federal retiree's entitlement to his own Social Security -- benefits that may have been earned through previous or part-time employment -- if that retiree is entitled to a federal pension not based on Social Security. Federal retirees with less than <u>an additional</u> 30 years of Social Security-covered employment often see their earned Social Security benefit reduced by as much as 50 percent.

Health insurance benefits in the federal sector continue to represent an area where federal workers receive inferior benefits compared to average private sector workers. A 1989 study mandated by Congress and completed by CRS with assistance from experts in the health care field continues to be the model on which federal vs. private health care discussions can be based. (The Federal Employees Health Benefits Program, Congressional Research Service, May 24, 1989)

The CRS study concludes that "A comparison of Federal benefits with those in the private sector shows that health benefits for a typical employee are worth $1,100 more in the private sector." Typically, private sector employers bear the entire health insurance premium for their workers and roughly 75 percent of the premium for dependent coverage. The federal government currently pays an average of 72 percent of its employees' health insurance premiums.

Yet, this Committee had earlier suggested as part of its FY 96 Reconciliation instructions that health insurance premiums paid by the government as employer should be capped. Furthermore, the Committee proposal suggested that future increases in premiums should be shifted away from the government and on to the enrollees. This scheme would have increased the government's share of future premium increases by only the simple rate of inflation. While increases in the Consumer Price Index (CPI) have hovered around three percent over the last several years, health care inflation has run well above those levels. In fact, over the last five years, health insurance premiums for medium and large firms have increased an average of 10 percent. Cost shifting of the degree suggested in this proposal is abhorrent and ignores the fact that 400,000 eligible federal workers already decline health insurance coverage, largely because they cannot afford the premiums. In its analysis of this proposal, even the nonpartisan CBO pointed out to Congress that the "downside" of this change is that when premium rates rise faster than inflation, enrollees will pay an ever increasing share of the premiums.

Despite these facts, there are those who will continue to come before this Congress and claim that the FEHB program is overly generous. It is ironic that I have never heard these critics point out how federal workers, unlike private sector employees, are constantly subject to legislated benefit changes such as prohibitions on abortion coverage and restrictions on family planning services that are unheard of in the private sector.

In conclusion, Mr. Chairman, the employees represented by NTEU are devoted to providing services to their community and their country. They are hard working public servants and they deserve to be treated with respect. They deserve to be compensated fairly for their work. The public sector should serve as a yardstick for the private sector to emulate. There are many valid reasons why the public sector should lead, not lag behind the private sector. This Union will continue to use every opportunity to share the facts concerning federal employee pay and benefits with the Members of this body and the public. And we will continue to vehemently oppose proposals which serve to belittle and disparage the federal workforce.

Thank you for the opportunity to provide this testimony in conjunction with your hearing comparing private and public sector compensation practices. I look forward to continuing to work with you on these issues.