BENEFITS: THE FLEXIBLE WAY

Senior Honors Thesis

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INTRODUCTION

When most people think about their compensation, they tend to consider only their wage per hour earned. However, a compensation package includes much, much more than that designated wage. The benefits that the employees receive often make up a large portion, many times figured to be a minimum of forty percent, of this package. Those benefits originally were allocated to all employees in the same fashion, with the exception of seniority influencing the amount of some benefits. Recently, companies have begun trying a new approach--the flexible approach--to benefit packages.

In a broad sense, any employer consideration that employees view as a benefit is classified as one. Required benefits include Social Security from the federal government and unemployment compensation and workers' compensation from the individual state government. Although most benefits require an expenditure on the employer's part, this is not a necessity. Benefits not mandating an employer outlay are "nonfinancial extrinsic rewards." Two common examples of this are flexitime and voluntary, or employee-pay-all, insurance. According to the 1984 survey by the Opinion Research Corporation, almost one-half of the six hundred forty-one participants estimated that employers spent less than ten percent of employee salaries on benefits while seven percent felt that employers spent nothing on benefits [McCaffery(1988),3]. In actuality, employers spend a significant amount on employee benefits--a total of $691 billion in 1985 [Kozlowski & Oleksy,1]. In 1943, benefits were considered inconsequential; in fact, benefits "were on the fringe of wages" [McCaffery(1988),1], hence the term "fringe benefits" for any non-monetary form of compensation. However, soon employers were forced to look at the cost of these benefits. Although benefits are pay-dependent, the cost of benefits had been increasing faster than actual wages. Costs were rising due to an increase in the cost of existing programs; new benefits were not being added. Between 1951 and 1986, the amount that the average employer spent on benefits increased from $644 to $10,283, or 1497% [McCaffery(1988),6]. See Table 1 for a comparison of benefits as a percentage of payroll. Today's total current benefit costs equals the sum of:

salaries and wages
bonuses
Social Security
federal unemployment tax
state unemployment tax
workers' compensation
group life insurance
group hospital, surgical, and medical insurance
dental insurance
accidental death and dismemberment insurance
health maintenance organization fees
home health care
psychiatric services
state disability
profit sharing on stock bonus deferred compensation plans under the Internal Revenue Code Section 401(k)(2)
costs of executive dining rooms
holidays
recreation facilities
and any other incentive the employer decides to offer as a benefit.

By the early 1980s, benefits were recognized as the key element in compensation and in human resource planning. Benefits did not play an important factor in pay in the 1800s and early

TABLE 1
GROWTH OF EMPLOYEE BENEFIT PAYMENTS

Year	Payments as a Percent of Payroll	Payments per Payroll Hour	Payments per Year Per Employee
1979	41.2	$3.22	$6,823
1977	39.9	2.64	5,388
1975	37.6	2.31	4,731
1973	35.1	1.78	3,677
1971	33.0	1.46	2,990
1969	31.0	1.19	2,460
1967	29.1	1.02	2,114
1965	27.1	.87	1,793
1963	26.8	.80	1,646
1961	25.8	.72	1,476
1959	24.4	.63	1,299

[Salisbury,41].

1900s for many reasons. Between 1840 and 1910, the United States work force was flooded with the cheap labor of immigrants; consequently, the pressure to provide benefits to employees was minimal. Also, if the wage system or factory life became too intolerable, then the workers had the alternative to go west and stake a claim. However, the Great Depression forced benefits into a new light [Salisbury,40]. With thirteen million people out of work and millions of people's personal savings being lost, government and industry recognized a need to protect workers against some of the uncontrollable risks associated with the loss of earnings. Over time, emphasis was placed on employee benefits for a variety of reasons: wage stabilization (1950-1953); the expansion of Social Security; the federal tax policy; federal social legislation; labor union efforts; employer initiatives; and the influence of insurance, financial, and benefit plan consultants.

As the value of benefits became more and more visible, problems with the current programs were recognized. Eventually, the limitations were discovered in the "monolithic" packages of benefits offered to an increasing diverse work force. The "prototypical employee"--the married male between the ages of 35 and 45 with two children preparing for college, a heavily mortgaged home, and two cars--for whom benefits were designed, was becoming harder and harder to find; in fact, he was becoming extinct [Kamerman & Kahn,288; McCaffery(1988),170]. Soon employers found that "benefit plans designed for an 'average' employee are not adequate to meet the needs of a work force comprised of 'nonaverage' people" [Kamerman & Kahn,252]. A vast majority of employers found that their plans, developed around a family with only the husband working, were obsolete. Victor J. Gilla, corporate manager of employee benefits of Ball Corporation in 1985, stated "We had difficulty identifying the 'typical employee' in our work force, so the standard benefit package didn't fit..."["Meeting Employees' Needs...",32].

The radical changes in the work force compelled employers to attempt to structure plans which would meet the needs of the employees more on an individual basis rather than trying to meet the needs of the group as a whole. Four factors, working in unison, changed the work force: the baby boom, women, education levels, and changes in the family and in lifestyles [Johnson,5; Kozlowski & Oleksy,2; Salisbury,5; Triplett,371]. The baby boom had grown up. Over one-half of the work force was under the age of thirty-five; these workers had different priorities and attitudes than their fellow, older workers. The number of women working was, and continues, growing (see Table 2). Not only were women with young children beginning to work more, but also older women were beginning to re-enter the work force. The work force is better educated at all levels, from high school to post-graduate. As the education levels increased, the expectations of the workers become more sophisticated, thus changing the view of benefits [Johnson,5; Triplett,371]. The family structure has been changed drastically with a delay in the first marriage, and with an increase in the average family size, in the divorce, remarriage, and separation rates, in the number of one-person households, in the number of people living together, and in the number of households with two or more workers. These changes are exemplified in the 1986 demographics: 45% of the work force were married with both spouses working, 25% were the single heads of households with no dependents, 20% were the 'traditional' families in which the husband worked and the wife did not, and 10% were single heads of households with dependents [Johnson,5].

The final factor which forced employers to reevaluate their benefit packages was the cost of health care [Fundamentals of... Programs,11]. Employee health care costs can be categorized as either direct or indirect. Health care services which are used by or made available to employees and to family dependents are classified as direct expenditures. Indirect costs are those that are the consequence of an illness or a disability, regardless of

TABLE 2
WOMEN IN THE LABOR FORCE

Year	Actual Number (thousands)	As a Percent of All Workers	As a Percent of All Women
1990(est)	54,253	46%	56%
1980	44,126	43	51
1970	31,560	37	43
1960	23,272	32	38
1950	18,412	29	34
1940	13,007	25	26
1930	10,396	22	24
1920	8,229	20	23
1910	8,076	21	23
1900	4,999	18	20

[Salisbury,44].

whether the provided services are used or not. Examples of indirect health care costs are absenteeism due to the employee's or a family member's illness, tardiness due to physical or mental illness, and productivity losses associated with the health status of the employee. Health care benefit costs have become a management control problem due to the real increase in the cost of health care services, inflation, and the change in the tax laws. Health care expenditures in the United States grew by an average of 13.9% per year for the five year period from 1976 to 1981 [McCaffery(1988),78]. See table 3 to see the growth of national health care expenditures. By 1985, ten percent of every dollar spent on goods or services was spent on health care [Lehman,1].

To help battle growing health care expenditures and to adapt to a changing work force, employers began looking toward flexible benefit plans. The concept of flexible benefit plans, whether

TABLE 3
NATIONAL HEALTH CARE EXPENDITURES

Year	DOLLARS (billions)	PERCENT OF GNP
1960	$ 27.1	5.3
1965	42.0	6.0
1970	74.9	7.5
1975	132.1	8.6
1977	169.9	
1979	212.2	
1980		9.5
1981	287.0	
1983		10.0

[Wolfson & Levin,10&11]

they are termed flexible benefit plans, cafeteria plans, cafeteria compensation plans, or flexible compensation plans, is relatively simple. (For the remainder of this paper, the term flexible benefit plans will be used.) Originally, the Internal Revenue Code defined a flexible benefit plan as one offering employees choices between benefits and cash; eventually the definition was expanded to include compliance with Section 125, which was added to the IRC by the Revenue Act of 1978. Section 125, entitled Cafeteria Plans, allows employees to choose between taxable and nontaxable forms of compensation. This section also requires three other features in a flexible benefit plan: 1) the plan must be written, 2) all participants must be employees, and 3) it must meet non-discrimination standards (i.e., higher compensated personnel cannot receive a significantly greater plan than lower compensated personnel). Basically, a flexible benefit plan is any plan allowing its participants to choose some or all of their benefits--whether the choice be among different levels of one type or among different types of benefits. An essential element of the flexible benefit plan is that it offer "an **individual** combination of benefits to each employee, rather than a standard program that covers all employees in the same way" (original emphasis) [Foster,155].

Although the benefits that each employer will offer in the flexible benefit plan will not be exactly the same, the IRC announced what could, as well as what could not, be offered. Allowable nontaxable benefits include accident and health insurance, dependant life insurance (up to $2000), disability benefits, group legal services, group term life insurance (up to $50,000), non-insured tax deductible medical expenses, and non-insured tax deductible dependant care expenses. Cash, dependant life insurance (over $2000), group term insurance (over $50,000), and vacation days fall into the category of allowable taxable benefits. Employees are allowed to defer their compensation only through the 401(k) plan. Few flexible benefit plans offer all of the benefits allowed; to do so would create severe administrative burdens on the employers. Items that are specifically to be excluded from a flexible benefit plan are as follows: deferred compensation plans other than a 401(k) plan, de minimis fringes (i.e., parking privileges, personal use of company office equipment and supplies, holiday gifts, company picnics), educational assistance benefits, no-additional-cost services, qualified employee discounts, qualified employer-provided transportation, scholarships and fellowship grants, and working condition fringes.

The concept of the flexible benefit plans entered literature early in the 1960s; however, it was not until the 1970s when employees were actually able to select the types or levels of benefits that were best for them. The Educational Testing Services of Princeton, New Jersey and TRW Systems Group of Redondo Beach, California both implemented their flexible benefit plans in 1974, the first year the concept was practiced. In the early plans, the choices that the employees were permitted to make were simple compared to the decisions of today. The choices consisted of whether or not they would participate in various segments of a plan or to what extent they would participate in certain types of benefits. However, the Revenue Act of 1978 changed the views on flexible benefit plans by providing the base for offering a choice between cash and benefits without being taxable if the plan was nondiscriminatory. The plan is determined by Section 125 to be nondiscriminatory if "1. It [the plan] is a collectively bargained plan or 2. Contributions made on each participant's behalf include an amount that (a) equals 100% of the cost of the health care benefit coverage of the majority of similarly situated highly compensated participants and (b) equals or exceeds 75% of the cost of the highest cost health coverage of similarly situated participants" [Johnson,7]. To be considered not discriminatory, the plan must also meet the "key employee" rule which states that the company must not provide more than twenty-five percent of total nontaxable benefits to key employees, as defined by pension law.

When flexible benefit plans were first introduced into practice, a majority of companies were reluctant to try them. This reluctance resulted from numerous elements. First, major tax barriers discouraging their use were present. Secondly, employers had become paternalistic and were averse to the idea of letting employees make decisions about issues as important as benefits. Lastly, the employers feared administrative complications and higher overhead costs. Nonetheless, more and more companies have recently switched to flexible benefit plans; by 1986, 28% of Fortune 100 companies and 14% of Fortune 500 companies offered flexible benefit plans [Finlayson,4]. What made companies suddenly decide to implement flexible benefit plans? In 1983, the Conference Board found that 99% of employers adopting a flexible benefit plan did so to accommodate varying employee needs, 88% did so to help control benefit costs, and 62% did so to help control the rising costs of health insurance [McCaffery(1988),171]. Three years later when Hewitt Associates surveyed flexible compensation programs and practices, they found that meeting diverse employee needs and containing costs were still the number one and two reasons, respectively at 90% and 80%, for implementing flexible benefit plans ["Cost Management Works...",66]. Another commonly stated reason is to increase the number of satisfied workers, in the attempt to improve employee relations and worker morale and to increase worker retention and productivity. By using a flexible benefit plan, employers are trying to make the employees more aware and more understanding of the value-to-cost ratio of the benefit plan. Also, tax restrictions have been eased somewhat to make it more feasible to switch to the use of flexible benefit plans. Statutorily, flexible benefit plans have been strengthened by 1) the Miscellaneous Revenue Act of 1980 which sanctioned the use of salary deferment through 401(k) plans, 2) regulations proposed in 1984 for Section 125, and 3) the Tax Reform Act of 1986 which changed the definition, as of January 1, 1989, of flexible benefit plans to be where employees can choose among two or more qualified benefit options. Finally, it is a simple case of "follow the leader," companies are competing with other employers--they want their plans to be as attractive as, if not more attractive than, their competitors' plans are. The whole time the employer is implementing this new plan, he is trying to improve his image--to show that he has a raised level of social consciousness [Salisbury,41].

The decision to implement a flexible benefit plan can be very beneficial to both the employer and the employee. The employer has numerous advantages to installing a flexible benefit plan. The employer should save money because benefits will not be offered to employees who do not really need them. Also, the employer can commit to a level of expenditure on benefits while offering a wider variety of benefits with the flexible benefit plan; where with a conventional plan, the employer promises set benefits, regardless of the final cost of the package. The flexible benefit plan creates a framework forcing the employee to work within a defined budget when structuring the individualized plan. As more and more employees shift their benefits from health care to other areas (i.e., vacations or savings), the costs of health care and benefits overall should begin to increase at a slower rate than has been experienced recently. Benefits should be priced in such a way that the less expensive ones are chosen more frequently than the more expensive one, resulting in further decreased employer costs. Also, the employer should have an easier time in effectively communicating the benefit program and its value to the employees.

The adoption of flexible benefit plans also has numerous advantages to the employee. They are able to select those benefits that meet their individual needs; in this way, the needs of different employee subgroups are optimized. Plus, the employees are taxed only on their individual choices and not on the total array of benefits which are offered. When salary reduction is used, the reduction is entered into the account before federal taxes and, with the exception of the 401(k) plan, before Social Security, and, in some case, even before state and local taxes are taken. The 401(k) plan offers additional advantages. In the short run, the plan helps the employee establish a regular saving habit; in the long run, the plan provides a supplement to the employee's retirement income.

For every company that decides to adopt a flexible benefit plan, there are numerous others that opt against converting. If flexible benefit plans are as great as some employers say, what stops all companies from changing? According to David J. Thomsen, director of the Compensation Institute in Los Angeles, "Cafeteria compensation [flexible benefit plans] has been one of the most overrated concepts ever championed by management theorists" [Thomsen,124]. One of the biggest reasons is that employers fear that the employee will be confused, resulting in poor choices. This theory presumes that the company is more competent than the employee in making decisions regarding the satisfaction level of employees. According to Douglas McGregor's Theory X-Theory Y model, this theory is indicative of theory X management [McCaffery(1988),186] which assumes that employees wish to avoid responsibility and desire to be directed by managers. A second reason is that flexible benefit plans allow for too much adverse selection, where the tendency is to select those benefits used often and reject those used infrequently. For example, a person with poor health may select the maximum amount of medical insurance and take a smaller option of another benefit.

Administrative complexity is another reason cited against flexible benefit plans; this burden will increase both the number of people and the amount of automation the company will need in order to administer the benefits. The resulting increased expense of time and of money also influence the decision against converting to the flexible benefit plan. Management will have to bear the cost of obtaining the employees' views during the formulation process, of pretesting and of simulations during the development of the plan, for the printed materials and for the meetings when the plan is implemented, and for the ongoing communication to prepare and to assist the employees in making advantageous decisions. In short, the funds needed to properly implement this plan are much more than those required with the traditional program. Many times union opposition prevents the implementation of the flexible benefit plan; unions seem to be content to negotiate benefits within the traditional framework. Unions claim management will reduce benefits when adopting the flexible benefit plan; management claims union leaders have no desire to relinquish their influential roles (i.e., if they are no longer attributed with bargaining the compensation package, then they have lost a valuable incentive in organizing strategies). Tax and legal uncertainties are final factors used when arguing against the use of flexible benefit plans.

Each of the reasons cited above to not implement the flexible benefit plan can be refuted. Although, initially, employees are overwhelmed with the prospect of making benefit choices, both professionals and nonprofessionals alike rapidly become accustomed to making informed choices. It is likely that some employees will make unwise decisions, but that should not be a reason for everyone to be deprived of the opportunity to experience the flexible option. Safeguards can be built into the plan in order to prevent poor choices on the employees' parts, and the plan can be developed to minimize adverse selection. According to Douglas J. Carey, a partner of Hewitt Associates,

"...for most of the larger, well-designed plans, the effects of adverse selection are minimal" ["Goals & Pricing...",14]. In spite of the fact that the costs may be greater with the flexible benefit plan than without it, the money is being put to better use; and the expense should become less of an issue as organizations become more familiar with and gain experience with flexible benefit plans. Once unions, like management, become more familiar with flexible benefit plans, they may also become more accepting of the idea and of its use. The tax and legal uncertainties involved possibly should not play as big a factor as they have in the use of flexible benefit plans. As one consulting firm put it "If American business deferred every decision until its tax and legal ramifications were entirely clear, our GNP would be running a close second to that of Outer Mongolia" [McCaffery(1988),189]. In-house personnel should work closely with external specialists in developing the plan and in keeping up to date on the current issues concerning the topic. In general, the anticipated problems with flexible benefit plans have been less severe than originally feared.

Medium and small firms which have implemented flexible benefit plans have tended to select one of five main structures. The reimbursement account, or flexible spending account, which became popular in late 1983-early 1984, is the simplest. This plan allows for the payment of certain expenses--health care premiums, medical expenses not covered by employer's tax-deductible plan, dependant care, and qualified group legal services--with pre-taxed dollars [Flexible Benefits...For You?, 21; Foster,168; Fundamentals of...Programs,188; Johnson,8; Kamerman & Kahn,249; McCaffery(1988),174]. The account can be either fully or partially employer or employee funded. Certain restrictions are applicable to the account:

1) elections for each type of benefit must be at the beginning of the plan year and cannot be changed unless there is a "life event," e.g., birth or death of a dependant, marriage or divorce, adoption of a child, loss of coverage by a spouse, change in employment status of spouse, or transferring divisions within the organization,

2) separate subaccounts must be set up for each expense category, and

3) the subaccounts are non-transferable (i.e., are on a "use-it or lose-it" basis).

The additional allowance, or the add-on approach, maintains existing benefits supplemented with optional benefits [Flexible Benefits...For You?,21,22; Foster,169; McCaffery(1983),177; McCaffery(1988),175]. Based on seniority, each employee is given a certain number of "flexible credits" to purchase the additional benefits. If their purchase exceeds the amount of credits received, then the difference is taken directly from their salary; if they do not spend all of their credits, then the difference is transferred into a 401(k) plan. This approach ensures that the employees are adequately protected by providing the essentials to everyone and then offering the opportunity to suit unique individual needs. This approach helps control costs because the employer regulates the amount of credits and the worth of each.

The mix-and-match option also works with the current package; however, the employee has the opportunity to select different levels of coverage within certain areas [Flexible Benefits...For You?,21,23; McCaffery(1983),175; McCaffery(1988), 175]. Choosing a lower coverage in one area allows the employee to select a higher coverage in another. Another alternative facing the employee is to choose mainly high coverages in all areas and to help pay some of the costs through salary reduction. This option grants the employee flexibility rather than directly affecting employer costs.

The core carve-out plan, or the core plus options, is similar to the additional allowance plan except where the additional allowance plan maintains the current level of benefits, the core carve-out plan reduces the current package to create a two part plan consisting of fixed core coverages and flexible coverages [Flexible Benefits...For You?,21,22,23; Johnson,11; McCaffery(1983),175; McCaffery(1988),176]. The core is usually a skeleton providing floor levels of certain benefits, typically included are a comprehensive medical plan, group term life insurance, partial income replacement during extended disability, pension plans, and standard paid time-off. The residual amount after the core has been carved out is the flexible credits. These credits can be used to increase levels of the coverages supplied by the core, to purchase additional benefits, or to convert to cash. According to Douglas Carey, "under both methods [additional allowance and core carve-out], you have essentially the same result, although they are priced differently" ["Goals & Pricing...",13].

The final structuring method used by medium and small firms is the modular plan [Flexible Benefits...For You?,22,23; Foster, 169; Johnson,9; McCaffery(1988),176]. This is a predesigned, prepackaged plan providing a number of modules each enveloping the same range of benefits but at varying levels of coverage. Each module is designed with the needs of a particular employee segment in mind. The number of modules offered depends upon the perceived difference in the variation between the employee segments in comparison to the price of administering two or more benefit packages. In some instances, all of the modules are of equal value; and in others, the employee must pay the difference when choosing a more expensive module. According to a survey conducted by Hewitt Associates, 67% of flexible benefit plans allow choices in benefits and a flexible spending account, 22% offer spending accounts only, and 11% allow choice-making only ["Cost Management Works...",64].

Larger firms implementing flexible benefit plans, however, tend to adopt a more comprehensive approach than the smaller firms do. The comprehensive approach is adopted as the knowledge about and the sophistication of flexible benefit plans increase. It is also a strategic decision technique used when a company is seeking to create a new look in employee benefits, particularly after an acquisition, a merger, or corporate restructuring. Each year, the employee chooses a level of coverage in required benefit groups; the employee is allowed to pick the most appropriate level of coverage but is not allowed to totally waive coverage in any one category.

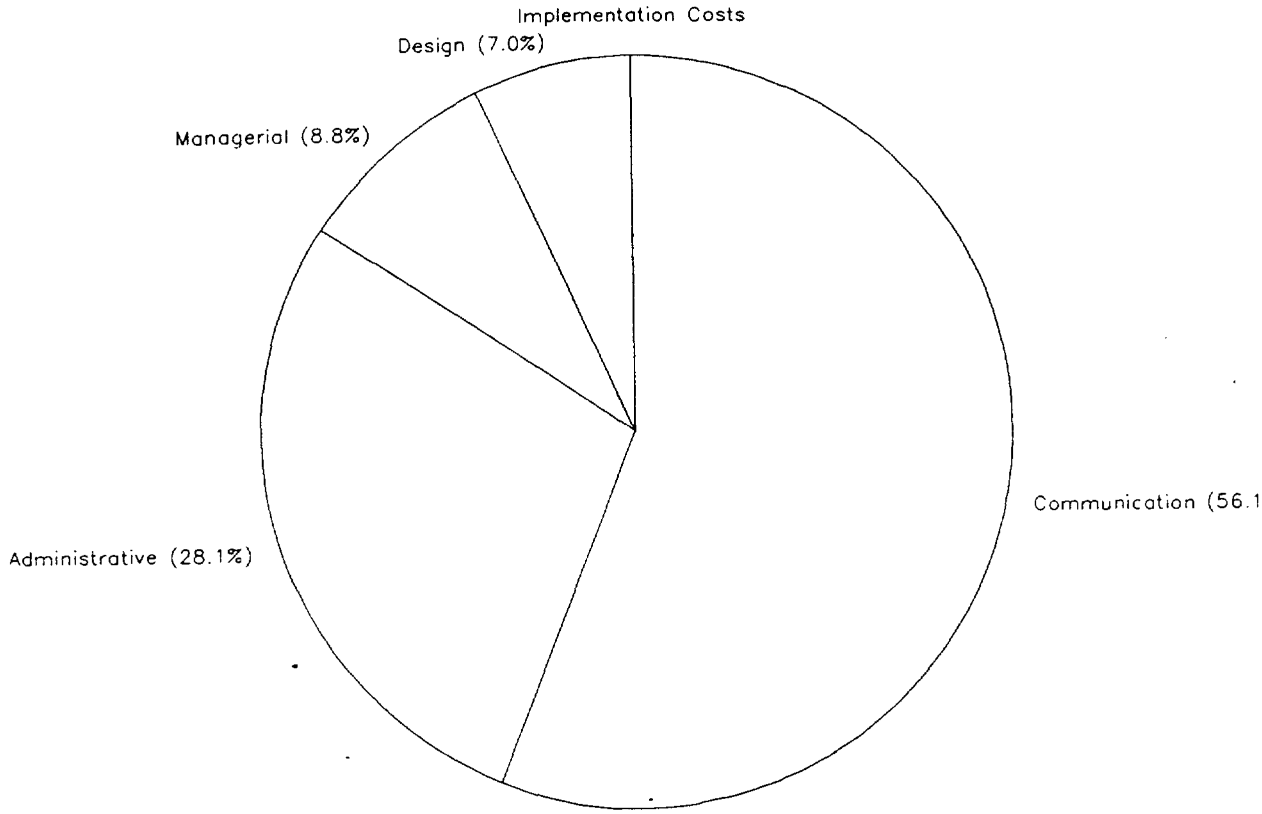
Companies decide to adopt flexible benefit plans for a variety of reasons, as was stated earlier. In general, how successful are these plans in accomplishing their intended purpose? According to studies conducted by the Human Resource Management Group from Alexander & Alexander Inc., more than fifty percent of the companies asked stated that their flexible benefit plans did not correct the problems that they were implemented to solve [Finlayson,3]. If employee satisfaction was a goal, however, the plans seem to be successful. After implementing their flexible benefit plan, management at Comerica perceived employees as having a higher level of job satisfaction; and employee feedback showed a greater appreciation of company benefits than it did with the traditional benefits package [Cain,24]. If employees have the opportunity to choose their benefits through a flexible benefit plan, then they become more aware of the value of each benefit and gain a greater appreciation for the company's compensation package as a whole. In addition, employees who have some choice in their benefits are more satisfied with their jobs, their salaries, and their benefits, says Equitable Life Assurance Society of the United

States. Their survey results show that fifty-five percent of employees who have a benefits choice are very satisfied with their jobs compared to forty-five percent who have no choice. An eight percent difference exists in salary satisfaction, from thirty-six percent with a choice to twenty-eight without; nine percent of the employees, forty-nine percent compared to forty percent, are happier with their benefits if they have selection opportunities [O'Hare, 32].

How valid is cost containment as a reason to convert to a flexible benefit plan? The switching costs are the first costs in question. Theoretically, if flexible benefit plans are designed and implemented properly, then they should be able to help contain costs. In reality, whether or not these plans actually help in controlling the cost of benefits is unclear due to a lack of experience with flexible benefit plans. However, many consultants feel that utilizing the flexible benefit plan has the potential to help control the costs. Part of the confusion in determining whether or not these plans help control costs results from the puzzlement of what to consider when ascertaining in the cost of the new program. For example, should the money spent at the initial stage of simply studying flexible benefit plans be factored in? What about the costs of installing the program? Or, should simply the cost of running the flexible benefit plan be considered? The costs of studying flexible benefit plans include the cost of outside consultants, of computer software, and of the staff time to implement and to administer the plan. This leads directly into the next questionable cost, the cost of implementation. These costs are dependent upon the complexity of the program being put into effect and upon the present system in use. The largest component of this cost is the communication element, followed by the administrative, and the managerial, and design elements, respectively (see Figure 1 for a percentage breakdown of the implementation costs).

A common sentiment is that flexible benefit plans can help control cost, in spite of the fact that the savings may not be realized immediately, especially when the implementation costs are computed in. However, it only took First Maryland Bancorp nine months to recover its implementation costs ["Cafeteria Plans...",30]. The size of the company will determine how much money will be required for a flexible benefit plan. According to a study conducted by Hewitt Associates, the initial set up costs of a choice plan average from $34,900 for a company with less than one thousand employees to $650,600 for a company with ten thousand or more employees; the average continuation costs range from $9700 per year to $54,800 for companies with less than one thousand employees and with ten thousand or more, respectively. The same study indicated that a flexible spending account costs anywhere from $17,300 to $96,900 to implement and from $3500 per year to $70,00 per year to maintain depending upon the number of employees ["Cost Management Works...",68]. In spite of the cost of flexible benefit plans, some companies boast of their success

FIGURE 1



[Rush,34]

with the plans. Hewitt Associates tells about a client that implemented their flexible benefit plan ten years ago and is saving money on their benefits, even though this was not one of their original objectives. Nevertheless, evidence has also shown that flexible benefit plans do produce some initial cost savings. However over time, the effectiveness of the plan diminishes and expenses eventually escalate to where they were before [Rush,31].

One of the biggest negative aspects of flexible benefit plans is the cost of the benefit package itself. However, flexible benefit plans do not operate in a vacuum; the cost of most of the programs has been affected by the same upward price movements that have affected everything else [Johnson,165]. Other reasons for the expense of flexible benefit plans are errors in the design and/or in the implementation of the program. The flexible package was not priced as low as the pre-flexible package was. Or, the cost of the benefits package was

miscalculated at the implementation stage.

According to one Ernst & Whinney administrator, the flexible benefit plan costs more than a traditional benefits program; but if the use of a flexible benefit plan attracts and retains turnover; it may assist in the reduction of the two, but it cannot be isolated as a determinant.

RESEARCH QUESTIONS

In a period where the use of flexible benefit plans has increased dramatically over the last decade, many reasons have been stated by companies for their decision to use the plan. "Cost containment," being one of the most important buzz-words when talking about employee benefits over the last ten years, is often one of the first reasons employers mention for shifting to flexible benefit plans; however, has the adoption of such plans, after original set-up costs, actually decreased the costs of benefits? In addition, has the use of these plans increased employee satisfaction resulting in a decrease in employee turnover and/or absenteeism?

METHOD

SUBJECTS

The individuals who helped to answer the research questions were persons involved in the personnel department of one hundred fifty companies in thirteen states throughout the midwest: Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Mississippi, Missouri, Nebraska, North Dakota, Ohio, South Dakota and Wisconsin. Each state had the opportunity for eleven companies to participate, with the exceptions of Ohio and Illinois, each having twelve, and of Indiana having sixteen. The companies which were asked to participate were determined randomly from the <u>Million Dollar Directory</u>, keeping in mind that only one company per city would be asked to participate.

PROCEDURES

The subjects were each sent an originally developed survey (see Appendix 1) concerning their company's use of benefits and whether or not they employed a flexible benefit plan. For those companies utilizing the flexible benefit plan, information about why the plan was adopted, about the types of benefits offered and about the structure of their plans was gathered. Also, the companies were asked about the effect of the flexible benefit plan on benefit costs, on employee absenteeism, and on employee turnover. For companies still utilizing the traditional benefit package, data was collected on why a flexible benefit plan had not been implemented and on the types of benefits that were offered. Both sets of companies were asked about their satisfaction level concerning their current plan and what they would like to see changed with the plan.

A short letter (see Appendix 2) was sent in addition to the survey. This letter explained the purpose of this paper and the intent of the survey. At the end of the letter, they were requested to participate in the survey.

ANALYSES

Size and Industry Differential. The analysis began with frequency tables constructed for all benefit variables with consideration to both the size and the business category of the company.

Benefits Satisfaction. An analysis of variance (ANOVA), a statistical test to locate the difference among means, was utilized in order to determine the level of satisfaction concerning the benefit plans between those employing flexible benefit plans and those with standard plans. The ANOVA was also used to discover whether either company size or business category is a factor in determining what benefits a company offers or in the level of benefits satisfaction.

Research Questions. In order to examine the research questions (i.e., the decrease in the cost of benefits, in employee turnover, and in employee absenteeism) the companies indicating the use of flexible benefit plans were scrutinized. The intention of this was to ascertain whether a decrease is actually present, and for those companies experiencing a decrease, whether the size of the company or the business category influences the decrease.

RESPONDENTS

Of the one hundred fifty surveys mailed, sixty-seven were returned for a 44.7% response rate. The majority of the respondents, 73.1%, were from small companies, employing two hundred or less workers. No one business category contained an overwhelming number of responses. See Table 4 for a complete break down of respondents by size and by business category. Examples of companies classifying themselves in the "other" category are service, agriculture, insurance, and utilities. Of the companies completing the survey, 85.1% did not utilize flexible benefit plans, while 14.9% had some kind of flexible benefit plan in use.

RESULTS

Upon analyzing the frequency tables, it was determined that the difference in benefits offered by the different size and the varying business categories is not statistically significant.

FLEXIBLE BENEFIT PLANS

Flexible benefit plans are offered by 14.9% of the companies responding to the survey. Fifty percent of those companies fall into the smallest size category; forty percent have between two hundred one and five hundred employees, and ten percent employ over one thousand people. The number of companies in the different business categories are a little more evenly distributed: thirty percent both from the retail and the "other" categories, ten percent each from the manufacturing and the hospitals/schools categories, and twenty percent from banking.

As was stated earlier, companies decide to implement flexible benefit plans for a variety of reasons. The results

TABLE 4
RESPONDENTS BY SIZE AND
BUSINESS CATEGORY
(in percent)

Business	1-200	201-500	501-1000	over 1001	Total
Retail	20.9	1.5		3.0	25.4
Hotel	1.5				1.5
Banking	7.5			1.5	9.0
Manufacturing	17.9	6.0		6.0	29.9
Hospital/School		1.5			1.5
Other	22.4	3.0	1.5	3.0	29.9
Not Indicated	3.0				3.0
Total	73.1	11.9	1.5	13.4	

support this, as well as indicate that the reasons are important in varying degrees to different companies. Accommodating diversified employee needs was a very important factor to one-half of the respondents when adopting their flexible benefit plans. The importance of this factor, along with controlling benefit costs and the increasing costs of health insurance, ranged from being important to being very important in all of the companies' decisions. (See Table 5 for a complete breakdown of factors affecting the flexible benefit plan decision.) Improving employee appreciation for benefits seems to have played one of the strongest roles in the conclusion to adopt the flexible benefit plan; the lowest this factor was rated was one step above "important." The two factors that have the widest spread in the implementation decision are the improvement of the absenteeism rate and of the turnover rate. In both cases, at least fifty percent of the companies do not feel that these factors were relevant to their decision; although, also in both cases, the

TABLE 5
FACTORS AFFECTING DECISIONS TO ADOPT FLEXIBLE BENEFIT PLANS
(in percent)

	Level of Importance						
	1	2	3	4	5	6	7
Accommodating varying employee needs				10	10	20	50
Controlling benefit costs				20	30	10	30
Controlling increasing costs of health insurance				10	30	20	30
Improve employee appreciation for benefits					20	40	30
Improve employee absenteeism rate	40	20	10	10			10
Improve employee turnover rate	20	10	20		10		30
Improve employee satisfaction			10	10	30	10	30

factor was important, in varying degrees, to some of the companies.

Not all the flexible benefit plans offer all of the benefits allowed by Section 125 of the IRC; to do so, as was previously stated, would create an administrative headache. Every company offers their employees accident and health insurance. Only ten percent of the companies offer paid vacation days--a benefit that most employees have come to expect. One half of the companies allow their employees to defer their compensation through the use of a 401(k) plan. Table 6 summarizes the benefits that are included in the flexible benefit plans.

TABLE 6
BENEFITS OFFERED ON
FLEXIBLE BENEFIT PLANS

	Percent offering	Percent not offering
Non-Taxable Benefits		
Accident & Health Insurance	100	0
Dependent Life Insurance	30	70
Disability Benefits	40	60
Group Legal Services	10	90
Group Term Life Insurance	50	50
Non-insured Tax Deductible Medical Expenses	60	40
Non-insured Tax Deductible Dependent Care Expenses	60	40
Taxable Benefits		
Cash	30	70
Dependent Life Insurance	30	70
Group Term Life Insurance	20	80
Vacation Days	10	90
Deferred Compensation		
401(k)	50	50

The structuring of the plans did not really fluctuate much. The reimbursement account is the most popular with forty percent of the plans being structured in this way. The mix and match options structure is utilized in thirty percent of the plans. Ten percent of the companies structure their plans as an additions allowance (add-on) account; a "premium only--packaged benefit plan," located in the other category, was also the structure of ten percent of the plans. Neither the core carve-out plan nor the modular plan are used by the responding companies.

Does the use of flexible benefit plans, as was asked earlier, actually decrease benefit costs? Forty percent of the respondents said that the implementation did in fact decrease these costs. The average decrease in benefits through the use of flexible benefit plans was 11.85%. However, forty percent also said that the use did not decrease the cost of benefits, while twenty percent did not know the affects of the plan on their benefit costs. Of those stating that benefit costs were not reduced, one company quoted a 7.51% decrease in the amount the employer contributed to FICA.

The survey shows that flexible benefit plans do not decrease either employee turnover or employee absenteeism. Seventy percent stated that the turnover rate was not reduced, while eighty percent said the same about the absenteeism rate. None of the respondents felt that either was reduced due to the adoption of the flexible benefit plan.

Although the results concerning the decrease in benefit costs, in turnover rate, or in the absenteeism rate are not as high as had been anticipated, the companies all seem very pleased with their current plan. Using the same scale as factors affecting the adoption decision, thirty percent rated their satisfaction level as a seven, forty percent as a six, and thirty percent as a five--all high satisfaction levels. Not many companies would make changes with their current plans. However, one company feels that their enrollment procedure is too complicated and expressed a desire to reduce the difficulty level. A couple respondents wished to enhance their current plan either through the inclusion of child or adult day care or through the addition of dental or vision insurance to their health plans.

Traditional Plans

Slightly over eighty-five percent of the respondents do not offer flexible benefit plans. A variety of reasons were given as to why this type of plan is not offered. Twenty-eight percent said that they have never even considered a flexible benefit plan. Twenty-three percent feel that this type of plan is too complicated to administer. The most common reason against the flexible benefit plan is that the company is too small; fifty-four percent of the companies gave this response. It is interesting to note here that ninety percent of the respondents giving this answer have under two hundred employees--the same category that fifty percent of those offering flexible benefit plans fall. Four percent of the companies felt that either there would be too much adverse selection or there is too much union opposition. The tax and legal uncertainties swayed nineteen percent of the companies away from flexible benefit plans. The fear that the employees would make poor choices did not affect any of the decisions. Twenty-one percent of the respondents cited other reasons for not implementing flexible benefit plans; some of the more common reasons are as follows:

1. The company has no say in the benefits offered; they are controlled by a corporate parent or a holding company.
2. The company is family owned; and in order to keep as much profit as possible, very few benefits are offered at all.
3. Management does not know enough about flexible benefit plans to offer them.

4. The employees were offered a flexible benefit plan, but not enough were interested to make the adoption viable.
5. Other projects have taken priority over benefit packages.
6. The benefits are purchased through a national association that does not offer the option of a flexible benefit plan.
7. The company does not offer any benefits, upon the advice of their CPA, due to the expense of benefits.

Although the majority of the respondents do not utilize the flexible benefit plan, most of them--all but one--offer some kinds of benefits to their employees. Over forty different benefits were listed as being given to the employees. Despite the large number, there were many common benefits. The ten most common, along with the percent offering each, are listed in Table 7. Tables 8 and 9 show what benefits are offered by companies utilizing standard benefit packages according to the size and to the business category, respectively.

Although the satisfaction level in respect to the benefits offered covers the entire spectrum, the respondents seem more, rather than less, satisfied with their benefit packages. Twenty-three percent said that they are only satisfied, a rating of four on the one to seven scale, with their packages. Twenty-five, eleven, and twenty-six percent of the respondents rate their satisfaction level at five, six, and seven, respectively. Only a total of eleven percent of the companies are less than satisfied with their benefits packages: four percent gave a rating of one, two percent a two, and five percent a three. A majority of the respondents were eager to tell what they would

TABLE 7
BENEFITS OFFERED ON
TRADITIONAL PLAN

	Percent of Companies Offering
Health/Medical Insurance	79
Life Insurance	56
Pension Plans	49
Short- & Long-Term Disability	37
Dental Insurance	26
Paid Vacation	25
Profit Sharing	21
Hospitalization	19
Paid Holidays	18
401(k) Plan	16

TABLE 8
BENEFITS ON TRADITIONAL PLAN
BY SIZE CATEGORY
(in percent)

	1-200	201-500	501-1000	over 1001
Health/Medical Insurance	57.9	7.0	1.8	12.3
Life Insurance	36.9	5.3	1.8	12.3
Pension Plans	40.1	3.5	1.8	3.5
Short- & Long-Term Disability	19.3	5.3	1.8	10.5
Dental Insurance	12.3	0.0	1.8	12.3
Paid Vacation	17.5	5.3	0.0	1.8
Profit Sharing	19.3	0.0	0.0	1.8
Hospitalization	14.0	5.3	0.0	0.0
Paid Holidays	12.3	5.3	0.0	0.0
401(k) Plan	10.5	0.0	1.8	3.5

TABLE 9
BENEFITS ON TRADITIONAL PLAN
BY BUSINESS CATEGORY
(in percent)

	Retail	Banking	Manufacturing	Other
Health/Medical Insurance	17.5	5.3	33.3	21.1
Life Insurance	14.0	5.3	22.8	12.3
Pension Plans	14.0	7.0	15.8	10.5
Short- & Long-Term Disability	10.5	1.8	14.0	8.8
Dental Insurance	3.5	1.8	10.5	10.5
Paid Vacation	3.5	1.8	12.3	7.0
Profit Sharing	1.8	5.3	8.8	5.3
Hospitalization	7.0	1.8	7.0	3.5
Paid Holidays	1.8	0.0	10.5	5.3
401(k) Plan	1.8	1.8	7.0	5.3

change with their current plan if they had the opportunity:

1. Add co-payment to the hospitalization coverage.
2. Change the life insurance coverage.
3. Shorten the waiting period for long-term disability to three months.
4. Add executive benefit coverages.
5. Add more coverages: child-care, long-term disability, health maintenance organizations, health and vision insurance.
6. Change the amount the employer is paying--some would decrease the amount, while others would increase it.
7. Change the structure due to complicated administration.
8. Redesign the package to take advantage of cost-containment possibilities for union members.
9. Decrease medical costs, both health insurance and short-term disability are too expensive.

FLEXIBLE BENEFIT PLANS VERSUS TRADITIONAL PLANS

Literature has shown that, generally, companies are more satisfied with flexible benefit plans than they are with standard packages. Do the survey results concur with these opinions? The average satisfaction level for flexible benefit plans is a 6.0 compared to a 5.11 level for those offering the traditional plan. Although the difference in the means is in the right direction, the difference is not of statistical significance according to the ANOVA conducted with $p<=.05$. Overall satisfaction for both types of benefits plans are summarized in terms of size and business category in Figures 2 and 3.

DISCUSSION

The variation of the respondents was not as wide of a range as it could have been. The results could have been improved had the response rate from the five hundred one to one thousand employee category been increased. Also, it would have been better had more hotels and hospitals/hotels responded. This last factor could have been blamed on the surveyor; possibly a set number of surveys could have been sent to each category rather than the purely random way which was utilized. Overall, the response rate was good; a response rate of almost forty-five percent is an extremely high figure.

The research questions were not able to be evaluated fairly with the small number of respondents actually utilizing flexible benefit plans. However, this rate really could not be improved by the surveyor. A number of the respondents did not answer the questions asked about the effects of their flexible benefit plan. The data received on these figures may have been better indicators had the respondents taken the time to determine the effects before returning the survey.

It was interesting to note that although the use of flexible benefit plans has not affected the absenteeism rate--nor was it

FIGURE 2

Benefit Satisfaction by Size

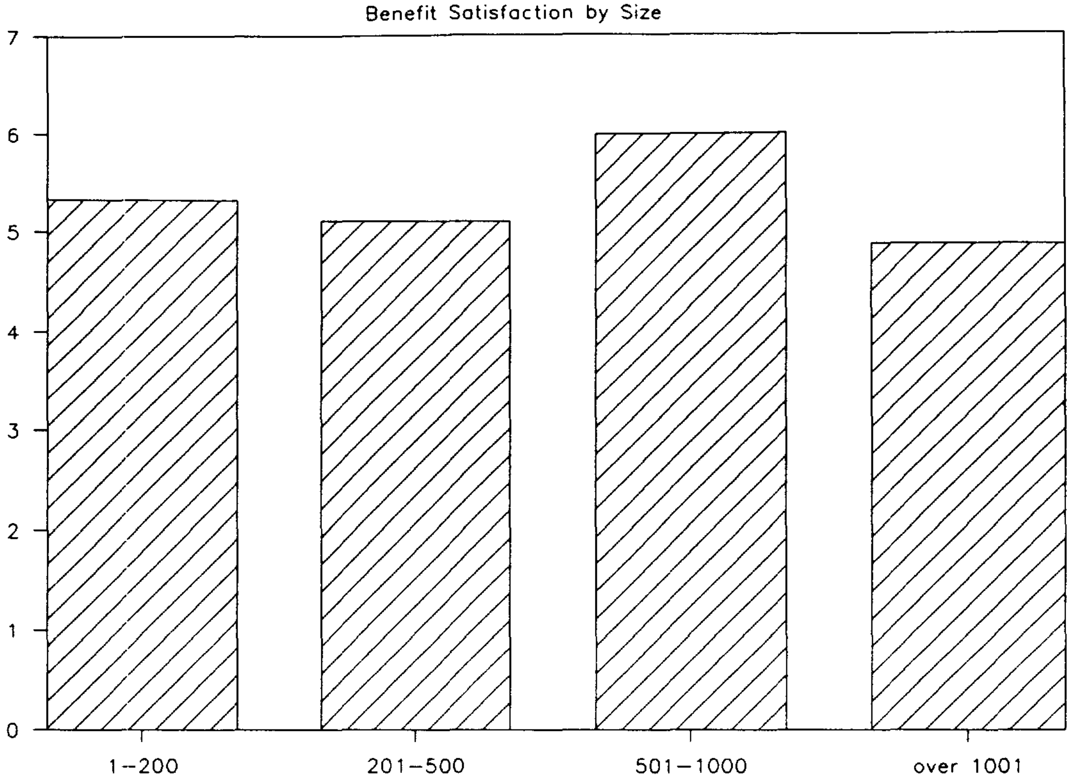
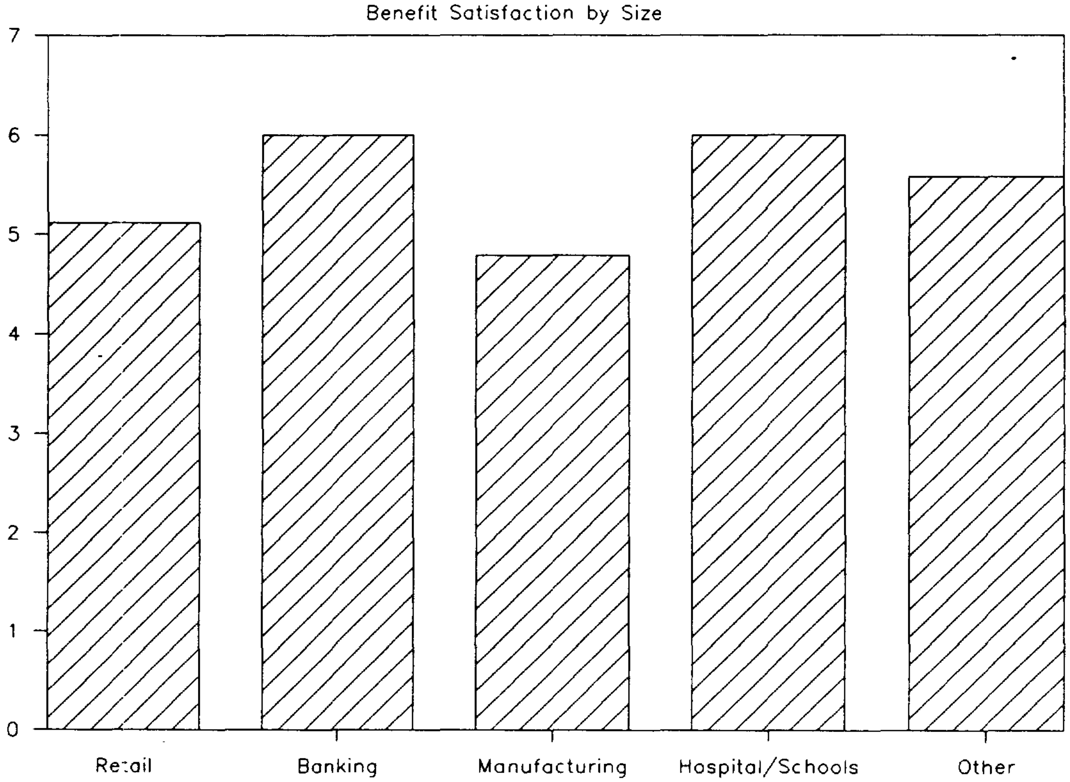


FIGURE 3

Benefit Satisfaction by Size



even a factor in the implementation decision--one company was working on the development of a paid-days off program to battle this problem.

Actually, most of the interesting comments came from those companies with the standard benefits package. One respondent expounded on his answer of not desiring to change his plan in any way by adding "If they don't work to my satisfaction they get fired. Keeps them working better." It appears to be a case of employment-at-will at its best.

The statistic that was most interesting was the number of companies that were considering adopting a flexible benefit plan; nine percent of those using a standard plan indicated the possibility of switching. If this nine percent actually decide to adopt the flexible benefit plan, then twenty-two percent of the companies which responded would be utilizing the flexible benefit plan. This goes to prove the idea that " 'Custom made' is the wave of the future as 'one size fits all' fades into the past" [Nation's Business,82].

APPENDIX 1

1. **How many employees do you have?**

____ a. 1-200 ____ c. 501-1000
____ b. 201-500 ____ d. over 1001

2. **Which category does most of your business fall? (Check one)**

____ a. retail ____ d. manufacturing
____ b. hotel ____ e. hospital/schools
____ c. banking ____ f. other __________

3. **Do you have a flexible benefits plan, a plan which permits employees to select benefits they want from a package of employer-provided coverage?**

___ Yes ____ No

(IF NO, PLEASE SKIP TO QUESTION 11)

4. **How did the following factors affect your decision to adopt a flexible benefit plan? (1 is not important; 7 is very important)**

a. Accommodating varying employee needs	1	2	3	4	5	6	7
b. Controlling benefit costs	1	2	3	4	5	6	7
c. Controlling increasing costs of health insurance	1	2	3	4	5	6	7
d. Improve employee appreciation for benefits	1	2	3	4	5	6	7
e. Improve employee absenteeism rate	1	2	3	4	5	6	7
f. Improve employee turnover rate	1	2	3	4	5	6	7
g. Improve employee satisfaction	1	2	3	4	5	6	7
h. Other (please explain)	1	2	3	4	5	6	7

____
____
____

5. **Which of the following non-taxable benefits are included in your flexible benefit plan? (Check as many as apply)**

____ a. Accident & health insurance
____ b. Dependent life insurance
____ c. Disability benefits
____ d. Group legal services
____ e. Group term life insurance
____ f. Non-insured tax deductible medical expenses
____ g. Non-insured tax deductible dependent care expenses

6. **Which of the following taxable benefits are included in your flexible benefit plan? (Check as many as apply)**

____ a. Cash ____ c. Group term life insurance
____ b. Dependent life insurance ____ d. Vacation days

7. **Do you offer a 401(k) plan?**

____ Yes ____ No

OVER

8. How is your flexible benefit plan structured? (Check one)

____ a. A reimbursement account
____ b. An additional allowance (add-on) account
____ c. Mix & match options
____ d. A core carve-out plan
____ e. A modular plan
____ f. Other (please explain) ______________________________

____
____

9. After original set-up costs, has the flexible benefit plan decreased benefit cost?

____ Yes; By what percentage? _______
____ No

10. Has the introduction of the flexible benefit plan decreased:

____ employee turnover? By what percentage? _______
____ absenteeism? By what percentage? _______

(PLEASE SKIP TO QUESTION 13)

11. Why did you not decide on a flexible benefit plan? (Check as many as apply)

____ a. Never considered a flexible benefit plan
____ b. Too complicated
____ c. Company is too small
____ d. Employees will make poor choices
____ e. There will be too much adverse selection
____ f. Too much union opposition
____ g. Tax and legal uncertainty
____ h. Other (please explain) ______________________________

____
____

12. What type of benefits do you offer? Please explain

____
____
____

13. How satisfied are you with your current benefit plan?

1	2	3	4	5	6	7
very dissatisfied						very satisfied

14. What, if anything, would you change with your current benefit plan?

____
____

APPENDIX 2

Ball State University

College of Business
Department of Management Science

^F1^
^F3^
^F4^
^F5^

February 24, 1989

^F2^:

Since you are involved in personnel/human resource activities, I am requesting your assistance. I am a senior at Ball State University in Muncie, Indiana majoring in personnel management and corporate finance. Currently, I am working on my Senior Honors Thesis; this is where I need your assistance. My thesis deals with flexible benefits and how their use affects employer costs, employee absenteeism, and employee turnover. I have enclosed a short survey and would greatly appreciate if you would take about ten minutes of your time to complete it and return it to me. Due to my own deadline in having to complete my thesis, I am requesting that you return the survey to me no later than March 17, 1989. If you have any questions regarding the survey, please feel free to contact my thesis advisor Dr. Jeff Hornsby at (317) 285-5306.

I have also enclosed the results of a survey that you may have had the opportunity to participate in last year. The survey, done by a fellow honor's college student, dealt with the use of application blanks.

Thank you in advance for your participation.

Sincerely,

Catherine Wallingford
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Ball State University
Muncie, IN 47306
(317) 285-3553

Enclosures

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