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EBRI Databook on Employee Benefits

Chapter1:
Employee Benefits in the United States: An Introduction

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Employee benefits are intended to promote economic security by insuring against uncertain events and to raise living standards by providing targeted services. Employee benefit programs also add to economic stability by helping to secure the income and welfare of American families, which helps the economy as a whole.

The U.S. employee benefit system is a partnership among businesses, individuals, and the government. Most employment-based benefits, such as pensions and health insurance, are provided voluntarily by businesses. The government supports these voluntary employment-based benefits by granting them favorable tax treatment. Certain other benefits, including Social Security, unemployment insurance, workers' compensation, and family and medical leave, are mandatory. The government also supports individual financial security programs through individual retirement accounts, favorable taxation of life insurance contracts, and tax-free death benefits.

A Brief History

Employee benefit programs have existed in the United States since colonial times. Early programs include the Plymouth Colony settlers' military retirement program in 1636; Gallatin Glassworks' profit-sharing plan in 1797; American Express Company's private employer pension plan in 1875; Montgomery Ward's group health, life, and accident insurance program in 1910; and Baylor University Hospital's formalized prepaid group hospitalization plan in 1929. The federal government's involvement in the provision of such benefits further expanded coverage. In 1935, Congress mandated basic retirement income protection under the Social Security program; in 1956, it added income protection for disabled workers and their dependents; and in 1965, it added health insurance for the elderly and disabled under the Medicare program. Moreover, voluntary employment-based benefit programs became more prevalent as federal tax preferences for employee benefits coincided with rising tax rates, strengthening incentives to provide private benefits.

The Role of Employee Benefits

Today's employment-based benefit programs represent a national commitment to provide

some measure of income security and access to certain services (especially medical care) to active workers, displaced and disabled workers, retirees, and their families.

Income Security—A family's income security can be threatened if a wage earner dies or becomes disabled. Group life insurance and long-term disability insurance, often provided voluntarily by employers, can help to alleviate such unexpected financial losses. Employment-based pension and savings plans can also help to provide economic security for workers who look forward to a period of voluntary retirement in old age. Mandatory government programs also address the need for income security. The Social Security Old-Age, Survivors, and Disability Insurance (OASDI) program provides an income base, in the form of a lifetime annuity, to nearly all retired and disabled workers and their surviving spouses. Workers who become unemployed or disabled may qualify for temporary unemployment insurance or workers' compensation payments, respectively.

Nearly all Americans will benefit from one or more private and public income security programs during their lifetimes. In 2009, 76.0 million workers (49.3 percent) worked for an employer that sponsored a retirement plan. Of these 76.0 million workers, 80.3 percent participated in an employment-based retirement plan (Copeland, 2010). In 2009, 34.1 percent of all elderly (age 65 and over) married individuals and 36.1 percent of all unmarried elderly individuals had income from employment-based pensions and/or an annuity according to EBRI estimates from the March 2010 Current Population Survey.

Mandatory government programs provide nearly universal coverage. In 2009, the Social Security system covered 156.0 million employees and self-employed persons, and 53.0 million persons, including the elderly, disabled, and their dependents and survivors, were receiving benefits. An estimated 88.4 percent of elderly married individuals and 90.1 percent of elderly unmarried individuals received income from Social Security in 2009 according to EBRI estimates of data from the March 2010 Current Population Survey.

Access to Important Services—The U.S. employee benefit system also seeks to provide American workers and their families with lifelong access to certain vital services, especially medical care. Many American workers participate in group health insurance programs sponsored voluntarily by their employers. Coverage may be limited to acute hospital care or may include such routine services as dental exams and physician visits. Often, an employee's dependents are covered. In 2009, 59.0 percent of the civilian population under age 65, or 156.1 million persons, were covered by employment-based health insurance (Fronstin, 2010). Among workers age 18–64, 68.2 percent had employment-based coverage.

Some employers sponsor health insurance benefits to retired employees. For some workers, the employer provides health insurance in retirement only until the retiree reaches age 65, the age at which an individual becomes eligible for Medicare, the federally sponsored medical insurance program for the elderly and disabled. In 2009, 34.0 percent of individuals age 65 and over received health insurance coverage from an employment-based plan according to EBRI estimates of the March 2010 Current Population Survey (see Chapter 36). In 2009, 93.5 percent of the elderly population received health insurance coverage through the Medicare program. However, Medicare's out-of-pocket expenses can be high. Therefore, some employers

provide health insurance coverage to their retirees who are age 65 and over, providing them with coverage for services not covered by Medicare.

Employee benefit programs are not limited to income security and health insurance. Specialized benefit programs help provide access to a wide range of important services, including ongoing education and training, child care, long-term care, and legal assistance. Other employee benefits, such as subsidized parking, product discounts, and relocation expense reimbursement, can provide convenience and cost savings for employees. Employee benefits also include paid sick leave, holidays, vacations, and maternity or paternity leave.

A list of employment-based benefits is presented in Figure 1.1. Although not exhaustive, the list shows the variety and range of the U.S. employee benefit system. Figure 1.1 also distinguishes between voluntary and mandated employee benefit programs and shows the wide variety of tax treatments that apply to these benefits.

Tax Treatment

Federal tax provisions for employee benefit programs are relatively new. The tax code has provided tax incentives since 1921 for employment-based pension plans, since 1939 for compensation received for injuries or sickness, and since 1942 for health plans. The Social Security program, as initially enacted in 1935, provided retirement income to workers and their spouses; in 1956, the program was extended to provide income to disabled workers (their dependents were included in the program in 1958); and in 1965, the program was extended again to provide health insurance coverage to the elderly, disabled, and low-income individuals.

The general tax treatment of employee benefit programs has remained relatively consistent over the years. Employer contributions to health insurance remain tax exempt to employees and tax deductible to employers; in addition, the benefits received under employment-based health plans are tax free. Taxes on most retirement programs are deferred until benefit receipt. Other benefits, such as life insurance, dependent care, and educational assistance, are tax exempt up to specified dollar limits. Vacations and other time-off benefits, bonuses and awards, and severance pay are fully taxable (See Figure 1.1).

Meeting Changing Needs

Given such a wide range of options, compensation packages can be tailored to achieve employer and employee goals and can change in response to workers' needs and preferences. Demographic changes in the American work force and general population have influenced, and are likely to continue influencing, the provision and design of employee benefit programs.

An Aging Population—One change in progress is the shift in the U.S. population's age distribution. Members of the large Baby Boom cohort (individuals born between 1946 and 1964) currently compose a disproportionately large part of the overall work force and are starting to enter retirement age (the first Baby Boomers turn 62 in 2008). As this cohort ages, and the smaller Generation X cohort (individuals born between 1965 and 1982) enters the labor force, the age distribution of the work force will shift toward older workers, whose needs and preferences may differ from those of younger workers. As the baby boom cohort begins to retire, an increasing proportion of Americans will be elderly and living longer and will depend on

sources other than employment for income and vital services. These forces will affect both income security and health care insurance programs. (Population pyramids of the United States: Source: U.S. Bureau of the Census)

Developments in the retirement plan market may in part represent a response to work force changes. It has been well documented that, in the private sector, participation in defined contribution plans (which promise a specified contribution to an employee's account) is growing faster than participation in traditional defined benefit pension plans (which promise a specified benefit at retirement). The percent of private-sector active-worker participants in a defined benefit plan where the defined benefit plan was the only plan declined from 62 percent in 1975 to 7 percent in 2009, while the percent of private-sector active-worker participants in a defined contribution plan where the defined contribution plan was the only plan increased from 16 percent in 1975 to 67 percent in 2009. The percent of private-sector active-workers who participated in both a defined benefit and a defined contribution plan went from 22 percent in 1975 to a peak of 35 percent in 1984 and 1985 to 27 percent in 2009 (U.S. Department of Labor, Form 5500 Filings, Pension Benefit Guaranty Corporation, Bureau of the Census, Current Population Survey, and EBRI estimates).

Defined contribution plans historically have offered faster vesting than defined benefit plans, and defined contribution lump-sum benefits are more portable than defined benefit plan deferred annuities. Thus, younger workers may anticipate future job changes and therefore place a higher value on faster vesting and benefit portability common to defined contribution plans. In addition, young families may be attracted to defined contribution plan provisions that allow access to money in the account prior to retirement in cases of financial hardship and on termination of employment (although preretirement and hardship withdrawals are generally subject to a 10 percent excise tax and regular income tax). However, as the baby boom cohort ages and the work force becomes weighted more toward older workers, preferences may shift again toward defined benefit plans, which are generally characterized as providing more secure retirement protection than defined contribution plans for long-tenure employees working at the same company until retirement. Also, it is possible to accumulate more money in the last several years before retirement in a defined benefit plan, for long-term employees, than in a defined contribution plan.

The effects of the aging population on retirement programs can already be seen in the Social Security Old-Age and Survivors Insurance (OASI) program. Partly as a result of increased life expectancies, past population shifts are reflected in a decrease in the ratio of OASI-covered workers to OASI beneficiaries from 16.5 in 1950 to 3.7 in 1970 to 3.2 in 2008. Under intermediate assumptions, the ratio of OASI workers to beneficiaries is expected to decrease to 2.1 in 2035 and to 1.9 in 2085 (Social Security Administration, 2010). In response, taxes imposed on employers and employees to finance the pay-as-you-go OASI system were raised from 1.5 percent in 1950 to roughly 4.8 percent in 1983. The rates were revised again under the Social Security Amendments of 1983 and increased incrementally to 5.3 percent in 2010. Moreover, in anticipation of the baby boom's retirement, the retirement age will rise incrementally to age 67 for people born in 1960 or later.

Health care benefit programs are also affected by the aging of the population. The elderly generally require more health care than the working age population. The effects of this trend on

medical expenditures are exacerbated by the rapid pace of health care price inflation. Between 1982 and 2010, the price level of medical services and commodities rose 304.4 percent, compared with a 127.1 percent increase in consumer prices overall. Propelled by these factors, national health expenditures reached 17.6 percent of the U.S. Gross Domestic Product in 2009, up from 5.1 percent in 1960. Between 1948 and 2009, employer spending for health insurance (excluding Medicare) increased an average of 12.6 percent per year, to $558.9 billion, according to EBRI calculations of data from the U.S. Department of Commerce, Bureau of Economic Analysis (see Chapter 2). In response to these developments, employers are taking steps to slow the growth of their health care costs. Increasingly, employers are requiring employees to share the cost of health insurance premiums and/or pay a larger portion of health costs out of pocket. It is hoped that cost sharing and other cost management measures will discourage unnecessary utilization of health care services.

The Medicare program, like OASI, has already been affected by demographic shifts and rapid health care inflation. The employer/employee tax rate for Medicare Hospital Insurance (HI) increased from 0.6 percent in 1970 on a maximum taxable amount of $7,800 of annual earnings to 1.45 percent in 2011, with no cap on the maximum amount of annual earnings subject to the tax. In anticipation of further cost increases, Congress changed Medicare's reimbursement system in 1983 to the prospective payment system (PPS) for inpatient hospital care and in 1989 to the resource based relative value system (RBRVS) for outpatient physician services. In 2003, the Medicare Prescription Drug, Improvement, and Modernization Act expanded the Medicare program by creating Part D, a prescription drug benefit which became fully implemented in 2006.

As the population ages, the proportion requiring nursing home care or other long-term care will increase. Currently, private insurance for such health care needs is not widely available, and federal financing for nursing home care is generally available only under the Medicaid program, with eligibility subject to stringent means tests. Many find this situation unacceptable, and pressure is building to make other provisions for financing long-term care, either through expanded provision of voluntary private insurance (perhaps through employers), through a mandatory government program, or both.

Balancing Work and Family—Family structure has changed radically from the days when it typically consisted of a father who was the sole wage earner, a mother who stayed at home, and two children. Today, both husband and wife often work, children are in day care, and there are many single-parent families. The increase in labor force participation by women, especially those with young children, has major implications for employee benefits. In 1950, 12 percent of married women with children under age 6 were in the labor force, compared with 61.6 percent in 2009 (U.S. Department of Commerce, 2000 and 2011). In 2009, out of a total of 74.2 million children, 51.8 million (69.8 percent) lived in a two-parent family; 16.9 million (22.8 percent) lived in a one-parent family (mother only); 2.5 million (3.4 percent) lived in a one-parent family (father only) and 3.0 million (4.0 percent) lived with neither parent (U.S. Department of Commerce, 2011).

These trends have led to public and private responses that attempt to help workers better balance work and family needs. Legislation has been enacted at the federal and state levels that

requires employers to provide a minimum period of parental leave and promotes federal and more state involvement in child care access, affordability, and quality.

Flexibility—Another response to a changing work force is the growing use of flexible benefit plans. Within such arrangements, employees are permitted choices among benefits and/or benefit levels. Employees thus may exchange benefits that they consider less valuable for others better suited to their needs. Employee benefit programs, whether public or private, that address these and other needs can enhance the economic security of individual workers and their families. The provision of benefits such as child care and parental leave can help smooth career progress, to the overall advantage of labor markets. Thus, these and other benefits can help families and employers reconcile the personal needs of the home with the economic needs of the work place.

Benefits and the Federal Budget

The expansion of federal tax incentives for employee benefits that occurred in the 1970s slowed dramatically in the 1980s and 1990s due to the federal government's budget deficits. Faced with billions of dollars in federal budget deficits in the 1980s and early to mid 1990s, legislators were concerned with tax losses attributable to tax-favored employee benefit programs. Because some benefits are tax exempt (health) and others are not subject to taxes until some future time (pensions), the current tax revenue loss to the U.S. Treasury can be substantial. Thus, employee benefits were often targets in legislative revenue-raising efforts. Starting in 1997, the federal government's budget went from deficit to surplus. This removed the threat of cuts in favorable federal tax treatment for benefits. But in the wake of the September 11th attacks, the evolving war on terrorism, the tax cuts for 2001-2003, and the financial crisis and Great Recession of 2007-2009, federal deficits have returned and the future tax treatment of benefits may again come under scrutiny. Employee benefit programs will remain an important piece of total compensation. Keeping up with and understanding the changes and their effects will be important not only for sponsors of benefit programs, but for employees as well.

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Figure 1.1

Selected Benefits

Types of Benefits by Tax Treatment

Mandatory

- Social Security retirement (OASI)
- Social Security disability (DI)
- Medicare Part A (Social Security HI)
- Workers' compensation
- Unemployment insurance
- Medicaid[a]
- Supplemental Security Income (SSI)[a]

- Public assistance[a]

Voluntary

- Fully Taxable
  - Vacations
  - Paid lunch
  - Rest periods
  - Severance pay
  - Cash bonuses and awards
  - Legal assistance
- Tax Exempt[b]
  - Employee and dependent health insurance
  - Retiree health insurance
  - Dental insurance
  - Vision insurance
  - Medicare Part B (Social Security SMI)
  - Educational assistance
  - Child care
  - Discounts
  - Flexible spending accounts
  - Parking
  - Cafeteria facility
  - Meals
- Tax Deferred[b]
  - Keogh plans
  - Defined benefit pension plans
  - Defined contribution retirement plans
    - money purchase pension plans
    - deferred profit-sharing plans
    - savings and thrift plans
    - employee stock ownership plans
    - stock bonus plans
    - simplified employee pension plans
    - individual retirement account plans
    - cash or deferred arrangements
      - 401(k)
      - 403 (b)
      - 457
- Other Tax Preferred[b, c]
  - Life insurance
  - Long-term disability insurance
  - Sick leave or sickness and accident insurance
  - Other leave (maternity, funeral, jury, etc.)

Types of Benefits by Function

Retirement Income Benefits

- Social Security retirement (OASI)
- Supplemental Security Income (SSI)[a]
- Keogh plans
- Defined benefit pension plans
- Defined contribution pension plans
  - money purchase pension plans
  - deferred profit-sharing plans
  - savings and thrift plans
  - employee stock ownership plans
  - stock bonus plans
  - simplified employee pension plans
  - individual retirement account plans
  - cash or deferred arrangements
    - 401(k)
    - 403 (b)
    - 457

Health Care

- Employee and dependent health insurance
- Retiree health insurance
- Dental insurance
- Vision insurance
- Medicare (Social Security HI, SMI)
- Medicaid[a]

Other Benefits

- Social Security disability (DI)
- Long-term disability insurance
- Life insurance
- Workers' compensation
- Unemployment insurance
- Public assistance[a]
- Severance pay
- Child care
- Vacations
- Sick leave or sickness and accident insurance
- Other leave (maternity, funeral, jury, etc.)
- Paid lunch
- Rest periods
- Legal assistance

- Education
- Flexible spending accounts
- Bonuses and awards
- Parking
- Cafeteria facility
- Meals
- Discounts

Source: Employee Benefit Research Institute.

[a] Eligibility based on need. Financed from general government revenues.
[b] Subject to conditions and limitations.
[c] Value of insurance and leave availability are not taxed; insurance benefits and leave pay generally are taxed when paid.