Increases in employer costs for employee benefits dampen dramatically

The Employment Cost Index shows employer costs for employee benefits in 1987 rose at less than one-third the 1980 rate

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Rates of increase in employer costs for employee benefits in private industry have fallen substantially since 1980. The 12-month rate of change, as measured by the Bureau's Employment Cost Index (ECI) for benefits, trended downward from 11.8 percent in December 1980 to 3.5 percent in December 1987.

The slowdown in the rate of increase for benefit costs was strongly influenced by reduced rates of wage and salary gains—from 9.0 percent in 1980 to 3.3 percent in 1987. (See chart 1.) Benefits closely tied to wage movements, such as paid leave, overtime pay, and Social Security, account for almost two-thirds of total benefit costs.

Despite the strong relationship between benefit cost and wage changes, the rate of increase for benefit costs usually remained above that for wages from 1980 to 1984. The disparity resulted from higher costs for health insurance, retirement plans, and legally required benefits, such as State unemployment insurance.

By 1985, however, several factors combined to eliminate the disparity. They included lower price increases for medical services, accelerated returns on pension fund investments, employer cost containment efforts in medical and retirement benefit plans, and moderate cost increases in legally required benefits. These factors kept benefit costs rising at about the same rate as wages and salaries for the past 3 years.

This article examines benefit cost changes in private industry during the 1980–87 period. It also describes how benefit cost changes, now published as part of the Employment Cost Index program, are calculated.

Calculating benefit cost changes

The Employment Cost Indexes for benefits, like those for total compensation and for wages and salaries, are fixed-weight Laspeyres measures of the change in the cost of employing a fixed set of labor inputs. The fixed weights—industry and occupation employment counts from the 1980 census—ensure that changes measured are unaffected by employment shifts among industries and occupations with different wage and benefit cost levels.

It is important to emphasize that benefit cost indexes are not price indexes for a fixed market basket of benefits. Rather, they measure the change in an employer's cost for providing a benefit package. This cost changes as new benefits (such as dental care) are added or when the cost for an existing benefit changes. The benefit costs may change in three ways: the cost for a benefit plan may increase or decrease (for example, the cost of 10 paid holidays rises due to a wage increase); the provisions of a benefit plan may be modified (for example, 10 paid holidays per year rise to 11); or the benefit plan may be eliminated.

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Trends within benefit categories

The Employment Cost Index survey covers five categories in the benefit package. For the private industry, *legally required* benefits make up approximately 30 percent of the total benefit cost to employers; *paid leave*, 25 percent; *insurance*, 20 percent; *pension and savings*, 13 percent; and *supplemental pay*, 8 percent.[1]

Legally required benefits. These benefits include Social Security, Federal and State unemployment insurance, workers' compensation, railroad unemployment insurance and retirement, and other benefits such as State temporary disability. Of these legally required benefits, Social Security is the most costly to employers, amounting to nearly two-thirds of the total cost for this benefit category.

During the 1980–87 period, cost increases in legally required benefits slowed, reflecting the deceleration in wage gains. However, significant increases in the Social Security tax rate in 1981 and 1984, combined with increases in the maximum salary ceiling, helped to keep legally required benefits rising faster than wages for much of the period. Table 1 lists year-to-year changes in the Social Security tax rate, in the maximum salary ceilings to which the rate applies, and in wage rates from 1980 through 1987.

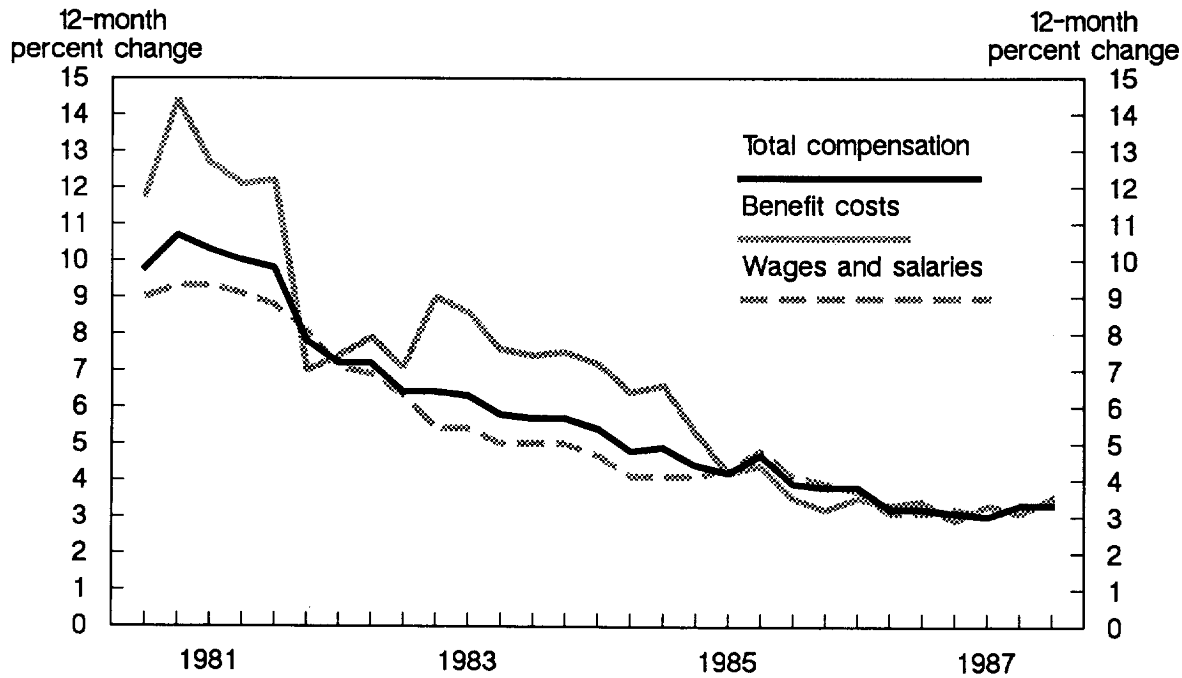
Table 1. Components of employer Social Security cost changes, private industry, 1980–88

Year	Social Security tax rate (percent of payroll)	Year-to-year percent change in tax rate	Social Security salary ceiling	Year-to-year percent change in ceiling	Percent increase in wages and salaries
1980	6.13	0.0	$25,900	13.1	9.0
1981	6.65	8.5	29,700	14.7	8.8
1982	6.70	.8	32,400	9.1	6.3
1983	6.70	.0	35,700	10.2	5.0
1984	7.00	4.5	37,800	5.9	4.1
1985	7.05	.7	39,600	4.8	4.1
1986	7.15	1.4	42,000	6.1	3.1
1987	7.15	.0	43,800	4.3	3.3
1988	7.51	5.0	45,000	2.7	—

The increases in legally required benefit costs were also stimulated by rising Federal and State unemployment insurance costs. The rise in costs for unemployment insurance from 1982 to 1985 followed the decline in unemployment funds as a result of the 1981–82 recession. To replenish those funds, many States increased their unemployment tax rate and taxable wage ceilings, or made special assessments on employers.

From 1985 to 1987, there were relatively small increases in the Social Security tax rate, and unemployment insurance costs dampened, as the percentage of unem-

Chart 1. Twelve-month percent changes in the Employment Cost Index for total compensation, wages and salaries, and benefit costs, all private industry workers, December 1980-87



NOTE: Data are for the 12-month period ended in March, June, September, and December. Data are not seasonally adjusted.

ployed civilians declined. These two factors slowed the rate of increase in legally required benefit costs. However, the legally required benefit cost change will rise again because the Social Security tax rate was increased to 7.51 percent in January of this year.

Paid leave benefits. These benefits include pay for holidays, vacations, and sick leave. Their cost to an employer is normally determined by multiplying the number of leave hours taken by the hourly wage rate and dividing by hours worked. Over the 1980–87 period, increases in paid leave benefits slowed at about the same rate as wage gains, as the number of leave hours remained steady. The Bureau of Labor Statistics survey of employee benefits in medium and large firms indicates that leave time was virtually unchanged over the period.[2] Table 2 compares survey results from 1981 (or 1982) and 1986.

Table 2. Average annual paid leave days for medium and large firms, private industry, selected years

Benefit[1]	Year and number of days	
	1981	1986
Holidays	10.2	10.0
Vacation days after:		
1 year of service	8.8	8.8
10 years of service	15.7	15.8
20 years of service	20.5	20.6
	1982	1986
Sick leave days[2] after:		
1 year of service	16.3	15.2
10 years of service	31.1	32.2
20 years of service	38.5	39.8

[1] Does not include "per disability" sick leave plans.

[2] 1982 was the first year for which sick leave averages were published.

Insurance benefits. Insurance benefits include life, health, and sickness and accident insurance. In this benefit category, health insurance accounts for the largest percentage of the total cost to employers.

From 1980 to 1983, employer insurance costs rose steadily, exceeding wage and salary gains. The rapid rise in insurance costs was greatly influenced by the rising cost of medical care as indicated by the Consumer Price Index (CPI–U) for medical services, which increased at the annual rate of 9.5 percent over the 4-year period. In addition to increased medical costs, insurance costs were influenced by the growth in health insurance coverage for additional medical benefits, such as dental, hearing, and vision care.

From 1984 to 1986, the rates of increase in insurance costs slowed. This slowdown partly reflected dampened increases in the cost of medical care, which fell to an annual rate of 6.3 percent during the period. However, cost containment efforts undertaken by employers were also an important factor in reducing the rise in insurance costs.

To reduce their expenses, many employers turned to self-funding instead of commercial health care insurance plans. Self-funding saved money by allowing companies to retain funds which would otherwise be used to pay insurance premiums, as well as giving the companies more control over plan design and expenditures. In 1980, only 16 percent of all major medical plan participants were covered by self-insured plans in medium and large firms; by 1986, the proportion had almost tripled to 45 percent.[3]

In addition to self-funding, there was a greater reliance on HMO's (health maintenance organizations). HMO's are prepaid health care plans that deliver comprehensive medical services to members for a fixed periodic fee. According to BLS survey results, 5 percent of the employees in medium and large firms were covered by HMO's in 1984, 7 percent in 1985, and 12 percent in 1986.

To further reduce costs, a larger proportion of employees were asked to contribute to the payment of health insurance premiums. The percentage of employees whose health insurance premiums are wholly paid by employers has declined sharply since 1980. Fifty-four percent of workers had individual coverage wholly financed by their employers in 1986, down from 72 percent in 1980. Only 35 percent could receive fully employer-paid coverage for their families, down from 51 percent in 1980.

In addition to requiring employee contributions for the plan premium, some health care plans were redesigned to eliminate basic coverage for certain types of care, and placed payment arrangements under a major medical plan. Under a major medical plan, the employees were required to pay a deductible (a minimum initial payment for medical costs made by the insured individual before plan benefits could be used).[4] The deductible requirement was an attempt to discourage unnecessary use of a plan benefit, thus reducing the cost of insurance. These major medical deductibles have increased over time to keep pace with the rising prices for medical services.

Finally, some cost savings were realized through changes in plan design that increased the employer's control over the type of health care available. Examples of these changes include requiring second opinions for surgical procedures and prehospitalization testing, as well as creating incentives to use outpatient facilities, buy generic prescription drugs, and audit hospital bills.

Retirement and savings plans. These benefits include pensions, and savings and thrift plans. In 1980, increases in retirement costs exceeded wage and salary gains. This disparity was a reflection of rising prices, as cost-of-living additives boosted pension liabilities under many plans, and of increased government regulation during the previous decade.[5]

However, from 1981 to 1987, a culmination of several factors, including the growth of defined-contribution plans, the use of dedicated bond portfolios, a rising stock market, and an increase in interest rate assumptions, caused a slowdown in the rise of pension costs.

Since the passage of the Employee Retirement Income Security Act (ERISA) in 1974, the growth rate of defined-contribution plans has outpaced that of defined-benefit plans.[6] As indicated below, defined-contribution plans helped many employers limit pension cost increases by acting as a substitute for more costly improvements in defined-benefit plans.

Defined-benefit pension plans use formulas for calculating the dollar amount owed to an employee and obligate the employer to pay that amount at retirement. These formulas are usually based on an employee's salary and years of service.

Current pension obligations for a defined-benefit plan are typically paid from a pension fund, to which employers usually make an annual contribution. The amount of the contribution required for a given benefit level is determined actuarially, and will fluctuate over time. Approximately 94 percent of defined-benefit plan participants in medium and large firms have their benefit wholly financed by their employer.

Defined-contribution plans, on the other hand, usually specify a contribution rate by the employer instead of a formula for determining benefits. Under these plans, contributions are typically made to an individual account for each employee. The employer's contribution is usually a fixed rate—for example, a fixed amount for each hour worked or a fixed percentage of compensation. The funds in these accounts are invested and the employee receives the proceeds upon retirement. In contrast to defined-benefit plans, only 70 percent of defined-contribution retirement plan participants in medium and large firms have their benefit wholly financed by their employer.

In general, defined-contribution plans offered employers lower administrative costs than defined-benefit plans. In addition, where employee contributions were required under defined-contribution plans, participation was often voluntary and below 100 percent. Further, defined-contribution plans typically do not reward the past service of an employee or provide postretirement cost-of-living adjustments, as many defined-benefit plans do.

Defined-contribution plans grew in importance because they not only provided employers with better control over pension costs, but they often gave employees some important tax advantages. Examples of defined-contribution plans include savings and thrift, profit-sharing, and employee stock ownership plans.

Some employers were able to further reduce pension cost increases by lowering their defined-benefit plan contribution.[7] This was accomplished by making changes in actuarial assumptions. Some employers utilized a Financial Accounting Standards Board (FASB) policy permitting a different interest rate (return on investment) assumption for disclosure purposes than for funding.

Table 3. Employment Cost Index 12-month rates of increase, December 1980–87

Series	Increase over 12 months ended December 1980–87							
	1980	1981	1982	1983	1984	1985	1986	1987
Total private economy:								
Wages	9.0	8.8	6.3	5.0	4.1	4.1	3.1	3.3
Benefits	11.8	12.2	7.1	7.4	6.6	3.5	3.4	3.5
Goods-producing:								
Wages	9.3	8.7	5.7	4.0	3.8	3.5	3.2	3.2
Benefits	10.9	12.8	7.3	7.0	6.2	3.0	3.1	2.9
Service-producing:								
Wages	8.7	9.0	6.7	5.8	4.4	4.7	3.0	3.5
Benefits	12.5	11.6	6.9	8.0	7.0	4.0	3.7	4.0
Manufacturing:								
Wages	9.4	8.7	5.6	4.3	4.4	3.6	3.3	3.4
Benefits	10.7	12.7	7.3	7.0	6.7	2.7	3.0	2.6
Nonmanufacturing:								
Wages	8.8	9.0	6.5	5.4	4.0	4.5	3.0	3.4
Benefits	12.7	11.8	6.9	7.9	6.5	4.0	3.8	4.0
White-collar:								
Wages	8.7	9.1	6.4	6.0	4.4	4.9	3.4	3.7
Benefits	12.1	12.5	6.8	7.5	7.1	4.2	3.7	3.6
Blue-collar:								
Wages	9.6	8.6	5.6	3.8	3.6	3.4	2.5	3.0
Benefits	11.1	11.8	7.3	7.3	5.9	2.5	3.1	3.4
Service workers:[1]								
Wages	8.1	8.3	8.5	4.6	6.2	2.3	2.8	2.4
Benefits	—	—	—	—	—	—	4.3	2.4

[1]Benefit cost data not published prior to 1986.

Using a higher interest rate assumption for disclosure has the effect of lowering the present value of pension liabilities.

While the growth rate in pension liabilities was being reduced, there was an increase in pension fund assets brought on by the rise in bond and stock markets. Some companies took advantage of high market interest rates to structure mini-funds—called dedicated bond portfolios—that matched fund income flows with their estimated pension liabilities. Because the yield on a dedicated portfolio was usually higher than the assumed return of the overall pension program, employers could reduce their contributions.[8]

In addition to developments in the bond market, the stock market behavior of 1982–87 expanded the stated asset value of stock portfolios. The rise in pension fund stock assets also had the effect of lowering employers' annual contributions. In fact, during the 1980–87 period, many pension funds actually became overfunded, temporarily eliminating all growth in employer pension costs.

Although the stock market fall of October 1987 lowered the asset value of many stock portfolios, most actuaries smooth out gains and losses over 5, 10, or 15 years, or more, for purposes of determining pension funding liabilities.

Supplemental pay benefits. These benefits include premium pay for overtime, shift differentials, and nonproduction bonuses. Premium pay and shift differentials are closely tied to wage movements. During the 1980–87 period, the rate of increase in premium pay and shift differentials slowed in tandem with wage gains.

Nonproduction bonuses are not closely tied to wage movements. Although highly visible, the impact of nonproduction bonuses on the total benefit costs of private industry employers is small.

One nonproduction bonus, the lump-sum payment, has gained some popularity in recent years. In general, collective bargaining agreements with lump-sum payments have averaged lower scheduled wage adjustments than those without them. Therefore, lump-sum payments have caused an increase in the ratio of benefit cost gains to wage rate gains. However, on average for all of private industry, the impact of lump-sum payments on the rate of benefit cost increase has been very small in comparison with the effects of other benefit costs.

Industry and occupational trends

Currently, the BLS publishes a series of industry benefit cost indexes consisting of separate measures for the total private, goods-producing, service-producing, manufacturing, and nonmanufacturing sectors. The published occupational series include those for white-collar workers, blue-collar workers, and service workers. For these published industry and occupational series, the trends in benefit cost gains have closely followed the pattern in total private industry since the series began in 1980. This behavior is consistent, because the nonwage factors affecting benefit costs (the costs of medical care, Social Security, and pensions) were economywide, not industry- or occupation-specific.

Over the 1980–87 period, the steepest declines in the rates of increase for wages and benefit costs came in the goods-producing, manufacturing, and blue-collar series. Factors such as the 1981–82 recession, foreign competition, and dampened inflation contributed to lower wage gains for these workers, and in turn, smaller benefit increases.

As expected, the gap between benefit cost increases and wage gains narrowed greatly over the course of the period for all series. Table 3 shows the December 12-month rates of increase in benefit costs and wages for each series during the 1980–87 period. □

FOOTNOTES

[1] See Felicia Nathan, "Analyzing employers' costs for wages, salaries, and benefits," *Monthly Labor Review*, October 1987, pp. 3–11.

[2] *Employee Benefits in Medium and Large Firms*, various issues (Bureau of Labor Statistics, 1981–87).

[3] *Ibid.*

[4] See Robert N. Frumkin, "Health insurance trends in cost control and coverage," *Monthly Labor Review*, September 1986, pp. 3–8.

[5] See Patrick J. Regan, "Pension Fund Perspective," *Financial Analysts Journal*, November–December 1984, pp. 10–12.

[6] See Employee Benefit Research Institute, *Employee Benefit Notes*, March/April 1985, pp. 4–9.

[7] Regan, "Pension Fund Perspective," p. 11.

[8] See Arlene Hershman, "Behind the Decline in Pension Costs," *Dun's Business Month*, May 1984, pp. 62–66.