

The changing needs of the company and the workforce have supplanted the tax code as the primary driving force in benefits design.

Beyond the Tax Code: **How Employee Needs Are Driving Benefits Design**

ALLEN T. STEINBERG
Employee Benefits Consultant
Hewitt Associates

It is difficult to reconcile the hypothesis that employees are more valuable with the way employers are cutting their benefit packages, particularly retiree medical coverages, traditional defined benefit pension plans, and employee medical coverages.

However, one place to start is by recognizing that the increasing "value" of employees does not necessarily translate into the pumping of additional dollars into a traditional benefit program. The amount of money spent is less important than **how** the money is spent.

Instead, the increased value of employees is being reflected in how benefit programs are being designed and delivered. For example, more employers are involving employees in the design process and addressing a broader range of employee needs in program design.

WHAT HAPPENED TO THE TAX CODE?

The tax code no longer is the sole driver of benefit design. What are the changing drivers of benefit design that have supplanted the tax code, and how do they relate to the

emergence of the new employment relationship?

The 1940s produced the beginning of dramatic changes in employee benefits. High wartime taxes on corporate income, including an excess-profits tax, sparked employer interest in the deductibility of retirement plan contributions. Wage stabilization programs in place during World War II (and later the Korean conflict) increased union receptivity to other forms of employer-provided compensation—namely, fringe benefits. Later in the decade, court decisions made pension and welfare benefits a matter for collective bargaining. Finally, advances in medical technology not only increased the efficacy of medical care but also raised the price, making it difficult for individuals to afford the cost except on a group basis. The result of these changes was a major shift in responsibility for security from the individual to the employer and widespread availability of employee benefits coverage.

In the decade following the enactment of ERISA (the Employee Retirement Income Security Act of 1974), the benefits area witnessed explosive growth. Two of today's benefits fixtures—the 401(k) plan and the "cafeteria" or

flexible benefit plan—were launched during this period. Congress also larded the tax code with incentives designed to influence employer conduct and provided special tax breaks for particular types of programs, such as tax-credit employee stock ownership plans and health care and dependent care spending accounts. In an era of relatively high corporate and personal tax rates, employers adopted plan designs to take maximum advantage of tax breaks for themselves and for their employees.

From a purely financial perspective, these tax-driven designs worked. Employers maximized their deductions and their employees' ability to shelter taxable income. Thus, benefit plans were deemed effective in meeting the needs of both employer and employees.

WHAT HAPPENED TO BENEFIT DESIGN?

The past six to eight years have witnessed a gradual but marked shift away from reliance on the tax code as a driving force of benefits design. Instead, employers are altering benefits because of a broader, more strategic willingness to address employees' needs—even when there is little or no tax advantage to providing the benefit. This is not to say that they are disregarding tax incentives or disadvantageous tax consequences. They are still using tax-favored designs where available and appropriate. But no longer are they contorting their programs to receive tax-favored treatment. Here are some of the factors that have contributed to this shift.

Decreased Attractiveness to the Employer

Under pressure to reduce the federal budget deficit, the federal government has significantly clamped down on the availability of tax advantages in the past decade. This has taken the form of outright elimination (such as the tax-credit ESOP) or the subtler form of additional restrictions and requirements. For example, the rules for funding defined benefit pension plans contain a dizzying set of limits intended both to encourage and dis-

courage employer funding. The impact on benefits of decreasing tax advantages and increasing restrictions has been magnified by the constant legislative tinkering with favorable tax status. No sooner has an employer settled on, and implemented, a program than the rules governing the program change. For example, from 1974 to 1984 Congress passed nine significant pieces of benefits-related legislation; from 1984 to 1994 it passed 20 pieces of such legislation.

So, employers have learned that programs that live by the tax break die by the tax break. They have also learned that pursuit of the tax code can be a treacherous journey and maximizing the tax-advantages for a benefits program can be an elusive goal.

Decreased Attractiveness of Some Benefits Options to Employees

As workforce demographics change, so does the value to employees of many traditional benefits. Defined benefit pension plans, for example—designed to reward long-service employees at retirement—aren't appealing to younger employees who don't imagine staying with one employer long enough to reap the benefit. Similarly, shorter vesting schedules in savings and profit sharing plans make these benefits more attractive to a younger, more transient workforce.

Increasing Employee Diversity

Once, the typical U.S. employee was depicted as a male who was the sole family wage earner. Today, a typical U.S. employee no longer exists. Baby boomers work alongside the baby busters of Generation X. Single parents share the same benefit plans as dual income couples without children. The American workforce needs benefit programs that reflect—and respect—their diverse needs. The popularity of flexible benefit or “cafeteria” plans reflects this desire; however, the tax code limits cafeteria plan offerings to a handful of benefits (including medical benefits, life insurance, and dependent day care). As a result, employers are finding other ways to meet employees' needs for flexibility *beyond* the limits of the

cafeteria plan, such as educational assistance, housing assistance, and health promotion programs.

The Lessons of Total Quality Management (TQM)

Although TQM initiatives often have different titles and use different approaches, there are some common denominators. One is that "quality" is defined by the customer. Another is an acknowledgement that employees understand business processes and can diagnose flaws and recommend ways to improve these processes. Thus, an organization that accepts TQM's logic listens to customers and looks for employee input to improve processes.

In the case of benefits, the customers are employees. So, TQM would require employers to evaluate the quality of benefit programs using their employees' definition of quality and then look to these same "customers" for input to improve their benefit programs. In effect, the logic of TQM leads employers to design around employee needs and definitions of quality rather than provisions of the Internal Revenue Code.

Increased Breadth of the New Employment Relationship

The new employment relationship requires a level of employee focus and "presenteeism" far beyond that of the old paternalistic relationship. Employees are being asked to work longer hours, take on more responsibility, and return more economic value to their employers. If employers want to maximize the contributions made by the "whole" employee in the new employment relationship, they need to address a range of needs far outside the traditional norm. For example, various "convenience" benefits, such as take-home meals and on-site dry cleaning and concierge services, can provide tremendous value in helping employees cope with the stresses and time commitments of balancing work and life.

Yet, the tax code makes little or no provision for many of the benefits that become valuable under the new employment rela-

tionship. So, employers are creating programs to meet these new exigencies—even if the tax code hasn't gotten around to acknowledging or providing tax incentives for these benefits. For example, many employers today offer child care and elder care resource and referral services to help employees manage their family needs even though there is no tax advantage to the employer in providing these services.

Distinguishing a Company in the Labor Market

Benefit plans driven by provisions of the tax code are a "commodity" that any employer can adopt. The only distinguishing feature between these commodity plans is the dollar amount paid, such as the differing amounts of employer matching contributions in 401(k) plans.

Rather than compete for employees through commodity plans, organizations that want to be employers of choice are seeking to distinguish themselves by adopting employee needs-driven designs, such as a paid time-off bank, an education savings account, or more options for medical coverage. These designs need not even be unusually inventive (although they often are). Rather, they recognize the needs of employees and where employees place value. Using employee needs as a driver allows these employers to stand out from the crowd.

For example, NIKE recently redesigned its compensation and benefit program using an employee needs-driven approach. The company used focus groups and written surveys to ask a wide cross-section of employees about their aspirations, needs, and fears. Based on the results, it designed and implemented a new compensation and benefit program called LifeTrek that helped it to concentrate its dollars on the issues that matter most to employees.

*Six trends
are
influencing
benefit
program
design.*

EVIDENCE OF THE TREND

A number of prominent, successful organizations such as Salomon, NIKE, Whirlpool, and Public Service Enterprise Group (highlighted in the case studies) already have

reshaped their benefit programs based on these new driving forces. These organizations are growing and succeeding in part because they recognize the value of employees under the new deal and use their benefit programs to convey that importance to employees.



ALLEN T. STEINBERG is an employee benefits consultant with Hewitt Associates, where he specializes in the design and implementation of retirement plans. He has contributed to Hewitt Associates' book on *Fundamentals of Flexible Compensation* and coauthored a book on qualified deferred compensation plans. He holds a B.A. from the University of Pennsylvania and a J.D. from Northwestern University.