C E Center for Effective Organizations

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STRATEGICALLY DESIGNED BENEFIT PLANS AS A SOURCE OF COMPETITIVE ADVANTAGE

Executive Summary

Employee benefit plans, which can add 50% to payroll and be neither understood nor appreciated by employees, can be a source of costly headaches for a firm. Strategic re-design of employee benefit plans can make them a source of competitive advantage.

We describe the symptoms of benefit plans "out of sync" with the general strategic objectives of the firm. These symptoms include employees receiving benefits based on family size or illness rather than the employees' value to the firm. Consequently, benefit plans do not reflect such core objectives as cost containment and the attraction, motivation, and retention of those employees most valuable to the employer.

Strategic design begins by identifying management's objectives for employee benefits. One central issue here is the degree of "flexibility" of the plan. (To the extent employees can convert pay into benefits, the problem is one of "total compensation" plans rather than "employee benefit" plans.) Increased flexibility may be the best way to enhance the firm's image in the labor market and help create a more productive and profitable mix of employees.

We then describe related management issues in the areas of: Tax/Legal; Administration (claims-paying and record-keeping); Finance; and Communications (with employees, shareholders, and the public). We focus on some key strategic considerations in each area, rather than attempting a review of all the technical matters.

We present some key implementation steps, including: (1) Creating an inter-functional task force, (2) involving senior management, (3) using a decision-style for plan design that fits the corporate culture, (4) dealing with issues of administrative capability, and (5) implementing the plan incrementally.

In closing, we make clear that our approach is <u>not</u> presented as the "one best way" to design plans. We realize executives may face constraints and possess values that make our approach infeasible. We offer our approach as one possibility to consider in an environment where both benefit costs and competition are increasing.

The bottom line is that traditional employee benefit plans are often out of "sync" with the firm's strategic objectives. Corporate expenses for health care, alone, are increasing at a rate that, if not slowed, will eliminate all profits for the average Fortune 500 firm company and the largest 250 nonindustrials.[1] A 1980 U.S. Chamber of Commerce survey of major corporations reported benefit payments representing 37% of payroll.[2] While we do not presume to know each firm's unique business objectives, we do assume that firms seek to attract, motivate, and retain productive employees at a reasonable cost. And the design of the employee benefit plan remains an underutilized tool for implementing this strategy.

Our central theme is that strategically designed plans can be a source of competitive advantage for the firm. We present ideas how executives can improve profits through better employee benefit management. We first identify the symptoms of plan designs that are out of "sync" with corporate objectives. Then we describe a framework for designing benefit plans from a strategic viewpoint that highlights the establishment of management objectives for the total compensation package, pay and benefits. Typical decisional/operational issues are reviewed for areas of: tax/legal, finance, administration, and communication. The key "red flags" in these areas are the focus, rather than the technical "nuts and bolts" of tax law and mortality tables that are available from other sources. We conclude with a discussion of the steps firms can follow in implementing this framework and their plan of choice.

The Symptoms of Plans "Out of Sync" with Strategy

Employee benefit plans traditionally display a number of symptoms that appear inconsistent with the firm's overall strategic objectives, including:

- The distribution of benefits is often inconsistent with the overall philosophy of compensation.

While many managers may believe in equal pay for equal work, most benefit plans are inconsistent with this principle. Many firms provide workers who have families extra compensation in the form of dependent coverage under benefit plans. Equal pay for equal work would require that we provide everyone doing the same job with equal total compensation, regardless of family status. Relative to pay-for-performance, some benefits actually operate so that higher value employees receive proportionately less than lower value. An example is disability income programs which replace a higher percentage of income for lower-paid employees than higher-paid because of dollar limits on maximum benefits. Thus, a plan might provide 60% income replacement, subject to a $2,000/month maximum benefit.

More broadly, the costs and rewards of benefit plans are distributed randomly--not tied to any systematic assessment of employee performance or value. To illustrate this, consider a hypothetical company's payroll in Exhibit 1, whose regular payroll for 1,000 employees totals $30 million. Now consider the two major benefits paid by the company, the deferred benefit pension plan, 7% of payroll, and the medical plan, 6% of payroll, for a total of 13% of payroll (Exhibit 2). Relative to the defined pension plan, there is approximately a 1:4 ratio of current contribution to provide $1.00 of pension commencing at 65 for employee aged thirty versus one aged

fifty.[a] This is a clear case of discrimination against the younger worker--though not legally regarded as such.

Relative to the medical plan, Exhibit 3 presents the case of four employees who differ in age and family status; "True" medical rates are illustrative monthly premiums to cover a thirty-year old ($50) and a fifty-year old ($100) and dependents for a "typical" medical plan. Now look at the bottom line. Keeping in mind that all employees do the same job at the same salary, there is nevertheless, a spread of $225/month ($275-50) discriminatory contribution that the fifty-year-old, married with children, receives that the single person, aged thirty, does not!

Further illustration of the non-strategic orientation of medical plans is found in Exhibit 4. Remembering that over time a company's medical plan costs will be largely determined by actual paid claims, note that half of the workforce account for 0% of claims. That is, they have no eligible expenses that exceed deductibles. However, the company considers these employees to be as equitably compensated as those receiving reimbursements.

These examples portray a system where 13% of payroll is paid in a discriminatory manner, where the true program costs are distributed based not on a person's merit or value, but on the basis of age or whether employees or their covered dependents get sick.

The pension and medical plan examples, together, point to another sympton of poor benefit plan design:

- Many benefit plans create an environment of disincentives for the young and healthy, limiting the firm's ability to attract and retain these employees.

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[a] Actuarially, this ratio could vary somewhat depending on assumptions about mortality, investment earnings, etc. But it will always be more than 1:1

To aid thinking about this symptom, one can broadly depict the composition of the workforce as follows:

	Healthy	Sick
Young	1	2
Old	3	4

Quadrant 1 is clearly the "best profile" and quadrant 4 the worse if a corporate objective is to keep human resource costs (generally) and employee benefit costs (specifically) as low as possible. The highest value employee is, more arguably, also quadrant 1. Less arguably, many managers at least perceive or believe quadrant 1 as the more valuable, but nonetheless design benefit plans to support and enrich employees in Quadrant 4. In effect, the potentially higher direct compensation of the young and healthy is used as an internal subsidy of benefits enjoyed primarily by the old and sick.

The extent to which this design can compromise the competitiveness of the firm is underscored by the changing demographics of the U.S. population. The median age of the US is increasing; we are getting older as a country. This fact makes it more difficult for firms to "average down" the age of their workforce so as to rely more heavily on quadrant 1 employees than quadrant 4 employees. A key competitive advantage may be to do better, relative to competitors, in the mix of employees. In the next section we describe the role that a strategically-designed plan can play in achieving this mix of employees.

A Framework for the Strategic Design of Benefit Plans

As a framework for redesigning benefit plans, the first and most important aspect is setting management objectives. These will be influenced by subobjectives for the following areas: Tax/Legal; Finance; Administration; and Communications, relative to employees, shareholders, and public image. We will describe the key strategic attributes of each component, then describe a process for integrating these areas in benefit redesign.

Management Objectives

Strategic objectives for employee benefit plans should be established within the context of senior management's philosophy and attitudes on human resources--they must be framed within the "macro-vision" of the firm. The following questions should guide the establishment of objectives:

(1) How much does the firm want to spend on total compensation?

(2) How should the compensation "pie" be divided between pay and benefits?

(3) Recognizing the cost of direct compensation and the other costs of doing business, what level of expense is acceptable for a particular benefit? What level of cost is acceptable for a total benefits program? What costs will be shared with employees?

(4) What benefits are in the organization's indirect compensation program?

(5) What is the purpose of the benefit offering? Does the program play an important role in attracting and retaining workers?

(6) Which employees should be given/offered benefits within the program? Do we want the plan to do more proportionately for some employees than others--do we want to administer benefits in relation to the value of an individual to the organization?

Answering these six questions can guide management as it deals with the two key overarching objectives of the plan: cost containment and the enhancement of the quality of the workforce.

Cost containment. The first three questions address the issue of determining an acceptable level of costs for the benefit plan, in the context of the total compensation package. Benefit "costs" can be defined in two different ways: (a) as a percentage of total compensation, or (b) as an absolute dollar figure. Given the spiraling expense of benefits, their percentage of total compensation can remain constant or decrease only through an increase in the size of the total compensation package--assuming management is committed to offering comparable benefits to employees over time. If management remains committed to offering the same benefits without increasing the size of the package, then benefits will continue to grow as a percentage of compensation over time. Benefits costs defined as absolute dollars has a different set of implications. Holding the line on absolute dollars mandates some combination of changes in their percentage of total compensation or the benefits employees receive. Regardless of the definition of costs, there are some very specific tactics useful for cost-containment that we will discuss later.

Another key considerations here is whether to state the plan's objectives in terms of total benefit costs, or in terms of total benefits to be provided. The "lesson learned" by firms with spiraling costs is: state the plan's objectives in terms of total benefit costs. The failure to set and meet targets for total benefit costs results in benefits driving costs, rather than the reverse. Firms have paid the price of stating objectives in terms of benefits to be provided rather

than on the costs to be incurred. Thus, when the costs of health care, for example, exploded, the employer was locked into a level of coverage rather than a level of cost.

Workforce Quality. The last three questions deal with the relationship between the composition of the workforce and the degree of flexibility in the plan's design. Very generally speaking, flexible plans are those that give employees an opportunity to choose between pay and benefits in a "cafeteria" format.[3] This concept is gradually replacing the traditional approach of giving all employees a fixed package of benefits as an automatic add-on to their direct compensation. Although the popularity of flexible plans has increased in recent years, 80% of firms still use essentially a fixed plan.

Flex plans can assume many forms and a variety of alternative flex plans are described in Appendix A. We suggest that the full flexibility/max cash option is the most effective remedy to the problems we have just described. In this plan, all benefits start from a cash base. The firm then adopts a rating system that reflects appropriate concern for any discrimination caused by age, family status, geography, etc. Employeees pay their own true share of benefit costs. This does not cost the employer any more, because it is just shifting costs within demographics of the population.

The way in which a strategically designed plan can become a tool of competitive advantage in the attraction, motivation, and retention of high value employees is demonstrated in Exhibit 5, which details job offers by two companies. Company A offers a standard benefit plan; Company B, however, offers flexibility in a way that highlights direct pay. The advantage, here, is that salary tends to be the far more

visible and sensitive component of compensation for employees, particularly among young and (presumably) more healthy workers. Thus, Company B's benefit plan may be a source of competitive advantage, while at the same time its total compensation costs are the same as Company A's.

In closing this discussion, we want to be clear about what we have <u>not</u> said to this point: we have not advocated the corporate disregard of either the sick or old. Nor do we condem the "traditional" system: It may be perfectly appropriate in a given circumstance. We <u>have</u>, though, encouraged employers to carefully consider the consequences of the choices they have made, or failed to make, in the light of a possible new way of designing their benefit plans.

After working through these central management issues surrounding compensation, attention shifts to considering these issues in the context of technical matters relating to benefits.

<u>Tax/Legal</u>

As "promised," we do not offer a review of the technical considerations around "tax efficiency" in plan design or compliance with statutes (ADEA, ERISA, Civil Rights Act, etc.) or non-statutory rules or procedures (FASB). That is the stuff of volumes and incessant change. Indeed, the Tax Reform Act of 1986 consisted of approximately 2,000 pages of closely written changes to the tax code, approximately <u>1,000</u> pages directly addressed employee benefits. We highlight the strategic factors that are constant attributes of the benefits environment:

- IRS objectives and corporate objectives are often dramatically opposed.

Corporate objectives typically include basing compensation or employee value and cost containment. IRS objectives can conflict with

both of these. Relative to the compensation objective of offering more benefits to higher-value employees, the IRS makes it very difficult to discriminate in this manner. To qualify for tax-favored status, a plan must satisfy elaborate IRS rules and tests that prohibit "discrimination" in favor of highly compensated employees. For example, a retirement plan that gave senior management a 10% annual contribution while limiting rank-and-file employees to 7% would fail to qualify, notwithstanding the fact that the company could pay its managers a 10% bonus while limiting other employees to 7%.

Relative to cost containment, for example, the corporation may be trying to limit future liabilities for the firm by pre-funding retiree medical costs. The IRS, which is clearly interested in preventing the corporation from deducting any more today than absolutely necessary, limits the tax advantages for a company to pre-fund retiree medical benefits. But prudent management and equity among generations of shareholders may suggest this financial policy in light of the enormous potential liabilities inherent in retiree medical promises.

- Corporate counsel needs to react in the interval between passage of benefit-related legislation and issuance of final regulations.

Consider the following example: In 1978, Congress encouraged the establishment of cafeteria plans by adding Section 125 and re-established cash or deferred arrangements under new ground rules by adding Section 401(K). However, it was many years later that all the regulations covering these plans were finally issued by the IRS. Benefits legislation is often imprecise because legislators frequently are short on expertise about how benefit plans actually work. Corporate counsel must approve benefit plan design in the face of this

uncertainty. The question facing counsel is: what things are you willing to do with your plan while waiting to find out if what you do will or will not qualify once the regulations are issued? An aggressive counsel may proceed, confident that if the plan ultimately does not qualify, then it can be amended. More cautious counsel may wait until all the clarifying regulations are issued, even though this process may take years.

- Counsel must "juggle" often-conflicting statutes, regulations, orders, etc. at the federal, state, and local levels.

There is a continuing and complex legal debate over the extent to which ERISA (the Federal Employee Benefits law passed in 1974) pere-empts state regulation. States were permitted to continue to regulate "insurance," but that term was not clearly defined, and case law on the subject of employee benefits regulation is still evolving. Many states have enacted laws mandating minimum coverage levels, or employee rights under insured plans, which may conflict with federal law.

There is also a fundamental dichotomy in the concept of unlawful discrimination. To the EEOC, discrimination occurs when someone receives unequal treatment in the workplace due to age, sex, race, etc. To the IRS, discrimination in employee benefit plans occurs when members of the "Prohibited group" (Senior managers, highly compensated employees, and certain share owners) get more from plans than the rank-and-file.

<u>Finance</u>

Again, it is <u>not</u> the intent of this section to review mortality tables, the dynamics of asset management, accounting standards and guidelines for pension expense reporting, etc. We offer some core reminders, followed by some more general strategic considerations:

- Stay current with Financial Accounting Standards Board (FASB) statements on how benefit plans are accounted for on corporate balance sheets.

These are accounting rules that usually need to be followed. You need to be careful not to confuse these accounting numbers with the "true cost" of the plan: claims plus expenses, less investment earnings.

- Share benefit costs with employees consistent with actuarial realities.

Actuarial tables show expected claims--by age, sex, geography, height/weight ratios, drug use, etc. Most employers neglect these actuarial realities in terms of how benefit costs are integrated with pay into the total compensation program. The challenge for the firm is to think both strategically and actuarially about the costs of extending benefits (inducing retirement) to a newly hired 21-year old.

- More broadly, cost-containment can be built upon four tiers.

(a) Cost sharing.

A 1981 study by the Rand Corporation demonstrated a clear inverse relationship between cost sharing and reduction in utilization.[4] Cost sharing can be realized through: premium sharing, deductibles, coinsurance, exclusion of services, and the reimbursement of surgical fees based on schedules rather than reasonable and customary charges.

Additionally, those who have done research on how employees perceive the value of their benefits suggest that employees would place more value on their benefits if the amount of employee contribution was increased.[5] Their research indicates that employees generally undervalue their benefits relative to their actual market value and costs to the employer. Having employees shoulder some of the costs of benefits may help them more fully appreciate what they are receiving.

(b) Catastrophic protection.

Although companies need to share more expenses with employees, they also should feel morally obliged to protect the employee for unaffordable loss. This is accomplished by including stop-loss features in their plans that limit employee co-insurance payments in case of very large claims. (This definition of "very large" is highly subjective; what is a reasonable deductible to Employee A may be unreasonable to Employee B. This is why medical plans that offer different deductibles are often part of modern flexible plans).

(c) Preventive health care.

The plan should include financial incentives for the early detection of disease.

(d) Encourage use of the least expensive environment.

An increasing array of alternative health care settings (outpatient, home health care, extended care facilities, hospices, etc.) are available to employees. The plan needs to encourage the provision of treatment in the least expensive, medically appropriate environment.

- Move toward "more managed" medical care.

The strategic objective is cost-containment. This comes through more "hands-on" management of medical care costs, including: pre-authorization for hospital confinement, concurrent review of hospitalizations by a disinterested professional, case management of large claims etc.

Administration

Key strategic issues in the administration of employee benefits include:

- Reviewing alternative record keeping and claims systems to accomodate changing benefit strategies.

The real issue here is whether the advantages of voluntarily changing benefit plans (as opposed to changes dictated by tax/legal changes) outweigh the disadvantages of continuing the existing arrangement. Organizations have clear choices for deciding how to administer their benefit plans: One basic decision is whether to do it in-house or to use an outside provider. At a very pragmatic level, record-keeping and claims payments are jobs that involve a lot of interaction with employees. These can be done by hand, by mainframe, or by micro-computer. The use of computers is certainly favored in larger organizations. Complex tax/legal reporting requirements, and advancement in computer technology suggest further computerization of benefits administration.

- The interface between the Human Resources Management staff and the systems staff (MIS, EDS, etc.) needs to be adroitly managed.

There is often an organizational gulf between these two functions that must be bridged. Systems people must fully understand the implications of any plan change. (For example, an employee's pre-tax contribution to a Section 125 Cafeteria Medical Plan has different FICA implications than similar pre-tax contributions to a 401(k) Cash-or-Deferred Retirement Plan). Futhermore, this record-keeping is routine stuff that holds little motivating potential for the systems staff. From this standpoint, these jobs are probably best done close to the "source"--at a fairly low organizational level.

From the HR side, staff in Benefits or Compensation like to control their own destiny, keeping the data in their own hands. They particularly don't appreciate being "stuck" in the systems queue waiting

for their jobs to be run. Systems people, on the other hand, resent being badgered by HR people with unreasonable deadlines.

- Given computerization, the choice must be made between reliance upon the mainframe or reliance upon micros.

This factor is related to the preceding point in that reliance upon the mainframe tends to centralize administration in the hands of the systems professionals. Micros tend to put control in the hands of the HR people--as well as making data more available to employees. This choice will reflect turf politics, as well as less emotional considerations such as the availability of hardware and software and the computer expertise of the HR staff, systems staff and workforce.

Communications

Although discussed last, communication is an integral component of the strategic formulation of benefit plans. In developing a communications strategy, it is always helpful to consider the different intended audiences: employees, shareholders, and the general public.

- Employee communication is necessary both before and after design.

In 1974, legislation (ERISA) mandated that employees be given descriptions of their benefit plans and their legal rights under those plans. Compliance constitutes a minimum acceptable threshold of communication with employees; many companies do much more. Relative to doing more, the wisdom of giving employees a voice in decisions about workplace issues that are important to them (and few issues are more important to them than pay and benefits) is well-documented and, at least in "more progressive" firms, increasingly practiced. Firms seemed to have learned the behavioral science lessons of participative decision

making, using employee attitude surveys, and organizational development techniques for providing feedback.

Although firms may practice good behavioral science in the area of employee benefits, they often ignore the principles of effective communications. For example, employees are typically sent their benefit statements once a year, even though, at that time, they may have absolutely no need for benefits information. Employees who then seek information when they actually need it are often told, "Read your last statement." As record-keeping and claims payment data becomes increasingly accessible to line managers, "on-demand" benefits information will replace the traditional annual statement. This makes possible the efficient, timely resolution of compensation problems that may be troubling employees.

It is important to offer a "caveat" to the advice of openly communicating with employees about the design and administration of the benefit plan: If the plan contains the kinds of inequities we have described, sharing information about the plan with employees can leave certain groups of employees feeling hurt rather than helped. The moral of the story is to strategically design an equitable plan and then make that plan as public as possible. This is analogous to the more developed notion on the direct pay side of designing improved pay-for-performance systems and then eliminating the secrecy that typically cloaks pay administration.[6]

- Employers must be sensitive to the "message" perceived by employees when benefit plans are changed.

Almost inevitably, if the employer is trying to save money or reduce the rate at which costs are rising, there is a potential communication problem with employees. Employees must understand the

financial picture. If the firm also has the objective to permit employees more flexibility and initiative in designing their own plans, there is a different problem. Employees must know enough to make intelligent choices.

Regardless of the employer's actual motives for plan redesign, employee perceptions of those motives form when word of change first hits the grapevine. Consequently, firms need to, at the outset, clearly define the communication objectives of the plan and select and develop media for communicating accordingly.

- Management must keep shareholders informed of changes in the benefits plan.

This requirement is particularly true if the plan involves extensive future commitments such as retiree health insurance, defined benefit pensions, etc. Equity across generations of shareholders is an especially important concern.

- Benefits information shared with the public can shape the firm's image in the labor market and the community.

From the standpoint of public image and relations, benefit plans which have been redesigned to provide greater flexibility, or which have corrected historical "discrimination" based on marital status, age, etc., can be effective in helping to define a company's image.

Steps in Implementing Alternative Benefit Strategies

We have identified the key strategic factors that need to be addressed in formulating a benefit plan. Here, we suggest some of the key process steps surrounding its implementation.

- The plan's formulation and implementation needs to be guided by an inter-functional task force.

Given the cross-functional interdependence of issues surrounding a benefit plan, a task force staffed from all relevant functions is desirable. These functions would likely include: Benefits; Compensation, when separate from Benefits; Employee Relations, if unions are involved; Finance, including the accounting area, since benefits typically interface with the general accounting ledger; MIS/EDP, particularly when flexible plans are involved; Tax/Legal, for all the obvious reasons, including the less obvious need to know "up front" how aggressive the plan's design can be relative to interpretations of often vague legal statutes; and Insurance/Risk Management, if any benefits are insured (e.g., Medical). Insurance is often a key factor for small or medium size companies who are reluctant to take the risk of self-insurance.

- Involve senior-level management in the task force, if only at the outset.

The importance of upper management support for a change effort is old and, many times, vague advice. What does it mean in this case? First, the strategic objectives for benefits, the centering vision, should come from or be endorsed by the Compensation Committee of the Board of Directors. Ideally, a representative of the Board can sit on the task force.

Second, we recommend that the CEO attend the first meeting of the Task Force. The CEO can make certain that everyone is square on what's about to happen, which means doing several things with the Task Force:

(1) Clarify the strategic objectives of the plan. Benefit plans often lack a strategic focus because the individuals designing the plans were not thinking in strategic terms, themselves. And it would probably have been unreasonable to have expected anything else. The CEO must

identify the objectives for cost-containment, employee attraction, and so on, that the plan is to serve.

(2) Emphasize that to think of benefits as "fringes" is a misnomer; to manage them as fringes is a mistake. Benefit plans that comprise 25-50% of compensation packages are no longer appropriately labelled "fringe" benefits. They are clearly a "central" component in compensation. More broadly, as the HR function, itself, finally begins to shed its "fringe" status relative to functions such as operations and marketing, strategic benefit plan design is a means by which the HRM side of the business can really impact the bottom line.

(3) Facilitate the interaction of managers who may be unaccustomed to working together. Again, the task force is comprised of managers from different staff groups, e.g. Finance and HR. It is even common practice for Compensation and Benefits to exist as different departments. The CEO can be an initial integrative force. He can also be useful in resolving problems of scheduling and lead time that can cripple any effort to change. For example, if the program is to be effective by January 1, 1989, then the Legal Department must sign-off by June, 1988, the MIS group must have all systems changes ready by October 1, etc.

- The decision style for benefit plan redesign will reflect the overall management or corporate decision style.

This reality is shared with those consultants or Task Force chairs who are responsible for directing the Task Force's deliberations. The decision on benefit plan design is only one of hundreds that are made daily or yearly within the firm; it is unlikely that a company will change its basic, engrained operating methods to make the benefits decision.

Decision style will have a visible impact on how long it takes for the Task Force to design a program and put it in place. Intellectually, a plan could be designed in as little as half an hour. In reality, the time taken depends upon whether there is an empowered person present, as we just discussed, and the unique company environment, or culture, that shapes how decisions are made within the firm. For example, an East Coast Medical Center was an environment that was highly collegial, committee-oriented--lots of interaction and participation in workplace decisions. The design phase for their plan lasted approximately eight months; the map they produced displaying the players and processes for implementation was extraordinarily complex. In contrast, at a highly-centralized multi-division company, a complete flexible plan was designed in an afternoon by a committee of HR Managers.

- As flexibility of the plan increases, systems decisions become the controlling implementation concern.

For most firms, the choice for administering benefit plans in-house is a choice between mainframe or micro alternatives. The clear trend is toward increasing use of micros. They permit HR to be more active in administering and, if micros are a part of employee's work stations, even allow employees to access benefits information when they want it, rather than when the system chooses.

The administrative choice clearly must fit the particular corporate environment. For example, a chain of 16 hospitals headquartered in Texas uses its centrally located mainframe capacity for large number crunching jobs and relies upon micros in the peripheral locations for on-going administrative and operational requirements. On the other hand, a famous East Coast Medical Center keeps all benefits administration on a central mainframe. Interestingly, this Center's

management was "politically" committed to running benefits on the mainframe, given its recent, and expensive, purchase.

- Implementation can be incremental, one business unit at a time.

It may make sense to run a "pilot study" of the new plan. For example, one division can be the test case with others to follow. For example, a California-based multi-state employer put a new flexible plan in at a Philadelphia location first--because there was strong local pressure for a different plan--and "rolled in" other divisions and corporate headquarter staff over the next few years. This gave division HR staff an opportunity to see the new plan "work" in a kindred environment.

Another means by which to incrementally introduce the new plan is to cover all new hires under the new plan and allow present employees to choose between the old and the new plans. The new plan then becomes "the" plan through an ongoing process of hiring, attrition, and the choices made by the members of the workforce when the plan was introduced.

The Bottom-Line

Traditional employee benefit plans may be out of "sync" with organizational strategic objectives. If so, knowing how to design plans to fulfill these objectives can be an important strategic advantage. The framework for strategically designing benefit plans we describe offers decision-makers ideas to identify and seize opportunities to improve profits through better employee benefit management. And with a growing trend toward giving employees more of a say in the design of their own pay/benefits packages (the Flex concept), the non-strategic approach may be awkward to communicate and defend.

ENDNOTES

1. This fact was reported in R. E. Herzlinger and J. Schwartz, "How Companies Tackle Health Care Costs (Part I)," Harvard Business Review, July-August 1985, 69-81. The authors describe the experience of a cross section of Fortune "500" companies and top non-industrials, focusing on newer types of health plans and benefits designed to cut health care costs. Parts II and III of the report appear in HBR issues September-October 1985, 108-120; and January-February 1986, 70-80.

2. Chamber of Commerce of the United States, Employee Benefits, 1980 (Washington, D.C.: U.S. Chamber of Commerce, 1980).

3. There is a wealth of published material on flexplans and the cafeteria approach. We recommend, first, an overall reference source on total compensation, G. T. Milkovich and J. M. Newman, Compensation, Business Publications Inc., Plano, TX, 1984. A useful source for the benefits component of compensation, generally, is J. S. Rosenbloom and G. V. Hallman, Employee Benefit Planning, Englewood Cliffs, N.J.: Prentice-Hall, 1981.

   For more information on flex-plans and cafeteria approaches--how they work and the firms like TRW and PepsiCo that use them--see D. Gifford, "The Status of Flexible Compensation," Personnel Administrator, 20 (May 1984), 19, and S. J. Velleman, "Flexible Benefit Packages That Satisfy Employees and the IRS," Personnel, 62 (March 1985), 33-41. For an excellent discussion of the motivational implications of cafeteria benefit programs, see E. E. Lawler III, Pay and Organization Development, Addison-Wesley, Reading, Mass., 1981.

4. As reported in the Herzlinger and Schwartz Harvard Business Review series on how firms manage their health-care costs.

5. This finding appears in M. Wilson, G. R. Northcraft, and M. A. Neale, "The Perceived Value of Fringe Benefits," Personnel Psychology, 38, 1985, 309-320.

6. The argument for "openness" in compensation practices is that employees need to be aware of how performance-contingent rewards are acquired in an organizational setting if the rewards are to realize their motivating potential. Also, "openness" may be a factor that contributes to employee morale. This line of thought, and related issues, can be explored in: T. A. Mahoney and W. Weitzel, "Secrecy and Managerial Compensation," Industrial Relations, 17, 1978, 245-251; J. D. Burroughs, "Pay Secrecy and Performance: The Psychological Research," Compensation Review, third quarter, 1982, 44-54; and E. E. Lawler III, Pay and Organization Development, Addison-Wesley, Reading, Mass., 1981.

Exhibit 1

Sample Company - Cash Compensation

MANAGEMENT	# of Employees	Average Pay	Reg. Payroll	Supplemental Payroll For Mgmt. Bonuses
Executive	5	100,000	500,000	$250,000 (5 x $50,000 avg. bonus)
Sr. Management	20	75,000	1,500,000	$200,000 (20 x $10,000 avg. bonus)
Middle Management	75	60,000	4,500,000	
ALL OTHER				
Sales	200	42,500	8,500,000*	
Production/Technical	400	24,000	9,600,000*	
Administrative/Clerical	300	18,000	5,400,000*	
TOTAL	1,000	$30,000	30,000,000	450,000

* (base pay, overtime, incentive awards, etc.)

Exhibit 2

2 Major Benefit Plans Paid in Full by Company

	Annual Cost	% of Regular Payroll
1. Defined Benefit Pension Plan	$2,100,000	(7%)
2. Medical Plan	$1,800,000	(6%)
	$3,900,000	(13%)

Exhibit 3

Medical Plan

Employee:	A	A_1	B	B_1
Age:	30	30	50	50
Family Status:	Single	Married, w/children	Single	Married, w/children
"True" Medical Rates:				
Employee	$50	$50	$100	$100
Family	-	+87.50	-	+175
	50	137.50	100	275

All employees do the same job at the same salary and have the same years of service with the employer.

Exhibit 4

Paid Claims Under the Medical Plan

(Eligible expenses that exceed deductibles)

30% of employees/dependents account for 80% of claims

20% of employees/dependents account for 20% of claims

50% of employees/dependents account for 0% of claims

This distribution reflects neither pay-for-performance nor the relative value of the individual to the company.

Appendix A

Full Flexibility "Max Cash Option" — Employee can exchange benefits for cash equivalent, regardless of whether employee has other coverage.

"Working Spouse" Plans — Allows those employees with coverage available through a working spouse to "trade in" all benefits for cash equivalent; other employees must keep "core" benefits.

"Core" Plans — Employees automatically gets a core package of benefits. Can improve benefits by purchasing additional coverage.

"Modular" Plans — Employees can choose one of several benefit packages, typically of equivalent value. Choice is limited to selecting a particular module. Employee cannot mix-and-match benefits from different modules.

"Contributory" Plans — Employee is offered the opportunity to participate by paying some or all of the cost. There is limited opportunity to "design" the benefits package to suit individual needs.

"Free" Plans — Employee is provided with a fixed benefit package, as an "automatic" add-on to direct pay. No discretionary contributions required.

Employee contributions can be either

- pre-tax (salary reduction)
- after-tax (payroll deduction)

depending on plan design