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Pension Coverage Among Small Employers:
Facts, Figures and Analysis

Statement of

Emily S. Andrews, Ph.D.*

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Committee on Finance
Subcommittee on Private Retirement Plans
and
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Introduction

In 1983, roughly 44 percent of all nonfarm employees worked for an employer who did not provide a pension plan. The majority of these workers were employed by firms with fewer than 100 employees. Research has shown that the most important determinant of pension coverage is firm size. If small employers provided pensions in the same manner as larger employers, many millions of workers would have a pension plan. While studies have indicated how small employers affect pension coverage, relatively little research has been conducted to explain why many small employers do not provide pension plans.

Many definitions of small business have been used including ones relying on assets, sales and employment. In this testimony, employers are categorized by employment size. Very small employers are those with fewer than 25 employees and small employers are those with fewer than 100 workers. Very large employers are businesses with a work force of 1,000 or more.

This testimony discusses small employer pension coverage using statistics based on several data sources that have been made available recently. The first data set is the Current Population Survey (CPS) pension supplement sponsored by the Employee Benefit Research Institute (EBRI) and the Department of Health and Human Services and conducted by the Bureau of the Census. The second data set is the Small Business Administration's (SBA) match of 1979

Internal Revenue Service (IRS) tax records for corporations, sole proprietorships and partnerships to employment and payroll data. Tabulations based on these data were first published in the 1986 Small Business Report. The third primary data set is a 1985 survey of small employers which the National Federation of Independent Business (NFIB) conducted from their own membership. In addition, 1985 Bureau of Labor Statistics data for medium and large firms is cited for purposes of comparison. Using these data sets, it is possible to draw a much clearer picture of small business and their pension plans.

How Important Are Small Firms?

Small firms provide important employment opportunities for much of the population. According to the 1983 CPS pension supplement, 46 percent of all civilian nonfarm employees worked for firms with fewer than 100 employees. Furthermore, over two thirds of those workers worked for firms with fewer than 25 workers. Thus, nearly one-third of all workers (31 percent) worked in very small firms with fewer than 25 employees. At the other end of the spectrum, over one-third (36 percent) of all workers worked for very large firms -- those with 1,000 or more workers. Fewer workers worked for medium-sized firms. Less than one-fifth (19 percent) of the labor force worked for employers with 100 to 1,000 workers.

Despite considerable fanfare to the contrary, the employment share of small firms has probably remained relatively stable in recent years. The percent of private nonfarm workers in firms with fewer than 100 employees in 1983 essentially maintained the earlier 1979 46-percent rate. While shifts away from larger firms may be underway, particularly in manufacturing, a

strong increase in the employment share of small firms is likely to be observed only after many years.

Nonetheless, even today most employers are small. According to 1979 tax files, 38 percent of some 2.6 million corporations had fewer than 5 employees. Furthermore, 81 percent of all corporations had fewer than 20 employees. Relatively few corporations represent medium-sized and large firms. Sole proprietorships and partnerships are even more likely to be small. Out of 9.3 million sole proprietorships, 82 percent had fewer than 5 employees and 99 percent had fewer than 20 employees. Similarly, out of 1.3 million partnerships, 59 percent employed fewer than 5 employees and 92 percent hired fewer than 20 employees.

Small employers made a substantial, but smaller, contribution to business investment and sales compared to large employers. Corporations with fewer than 100 employees accounted for 21 percent of corporate assets and an estimated 28 percent of receipts. Large employers with 1,000 or more employees accounted for 61 percent of assets and an estimated 55 percent of receipts. Medium-sized firms with 100 to 1,000 employees held less than one-fifth (18 percent) of all corporate assets and an estimated 16 percent of receipts.

Small employers may be found in all industries. In very small firms, 10 percent of employees worked in manufacturing and 11 percent in construction. In addition, 32 percent worked in retail and wholesale trade and 38 percent in services. Slightly larger firms have a similar employment distribution but a greater proportion of manufacturing employment and a smaller proportion of workers in the service sector.

Workers in larger firms are also more likely to work in manufacturing and less likely to work in services. The share of manufacturing employment drops

most sharply for firms with fewer than 25 workers. The share of service employment increases most sharply for firms with 1,000 or more workers. In very large firms, 39 percent of employees worked in manufacturing in 1983 and fewer than 2 percent worked in construction. Similarly, in very large firms 22 percent of all workers were in the retail and wholesale trades and only 15 percent in services. Thus, employment in large firms is more concentrated in manufacturing and less concentrated in the service sector.

In sum, small employers account for a significant share of business assets, sales and employment and operate in a variety of industries. Nevertheless, there are significant differences in the structure of small and large firms. These differences have been persistent over time and probably reflect the most efficient size for different activities. The work forces of large and small employers may also be molded to particular production needs.

Does the Work Force Differ by Firm Size?

Small employers hire workers in many occupations which, in part, parallel the industries in which they work. In very small firms (fewer than 25 employees), 9 percent of all workers are managers and professionals and 16 percent are administrative and clerical workers. One-fifth of all workers in those firms are service workers; another 6 percent are construction workers and 18 percent are other production and craft workers.

The occupational distribution of small firms is different from that of large firms. In particular, large firms have a higher percentage of managers and professional workers (16 percent) and a higher percentage of clerical and administrative workers (20 percent). Although the proportion of non-owner managers is higher in larger firms, additional data would be needed to

determine whether the proportion of managers and owner-managers combined is higher. Very large firms employ a smaller percentage of construction workers (only 2 percent) and a higher proportion of other production and craft workers (27 percent). Large employers are also more likely to have unionized workers. While only 5 percent of very small firms are unionized, 31 percent of the workers in large firms are subject to a union contract.

These differences in unionization and occupation are not the only worker characteristics which differ by firm size. While firms of all sizes hire all types of workers, more teenagers aged 16 and 17 and more workers over age 65 work for very small firms than for very large firms. Similarly, very small firms are more likely to hire part-time employees who work fewer than 500 hours a year.

Workers in very small firms are also less likely to stay on the job. Only 12 percent of workers in very large firms were on the job for less than one year compared to 30 percent of workers in very small firms. Employees of large firms are also much more likely to have long tenure on the job. Before the 1986 Tax Reform Act, many employers selected a 10-year vesting standard for their pension plans. The proportion of workers who would have met such a standard in large firms is higher than the proportion in very small firms. Fully 36 percent of employees in very large firms were on the job for 10 years or more compared to only 16 percent of workers in very small firms.

Thus, while workers are found in a wide variety of occupations in both large and small firms, significant occupational differences exist. Furthermore, very small firms engage a smaller percentage of prime-age full-time full-year workers, the type of workers that were the originally focus of the 1974 Employee Retirement Income Security Act (ERISA). In addition, large-firm workers are generally on the job for longer than

small-firm workers. These differences in the type of workforce engaged by large and small firms suggest that there may also be differences in their wages and benefits.

A Comparison of Wages and Benefits

One of the most consistent findings of researchers is that small firms pay less than large firms. Using the May 1983 CPS pension supplement data, average annual earnings in very small firms were an estimated \$11,300 compared to an average of \$20,200 annually for very large firms. This finding generally holds across all occupations. For instance, among professionals in very small firms, average earnings were \$16,000 annually whereas they reached \$28,000 in very large businesses. Similarly, administrative and clerical workers averaged \$9,900 annually compared to \$15,800 for similar workers in large firms. Furthermore, other survey data suggest that managers are paid more in large firms as well. Nevertheless, according to the May 1983 CPS pension supplement, individuals in certain technical and professional occupations may have higher earnings in small firms. These occupations include mathematicians and computer scientists, health diagnosing occupations (including physicians), and lawyers and judges.

Studies show that the finding of lower pay in small firms is not simply an artifact of worker differences that are hidden in aggregate job classifications. Research has show that even when wage rates are adjusted for factors such as education, age, hours worked, union membership and other related factors, on average, workers in small firms tend to be paid less.

Workers in small businesses are generally also less likely to receive employee benefits than workers in large businesses. Benefit provision for

full-time workers in large and medium-sized firms in 1985 can be compared to that provided workers in small firms using the BLS and NFIB surveys mentioned earlier. According to these surveys, almost all large and medium firms provided their full-time workers paid vacations, while only 80 percent of the full-time employees in small firms (less than 100 employees) had paid vacations. While practically all full-time workers in medium and small companies had health and life insurance on the job, 75 percent of similar workers in small firms had health insurance and only 59 percent had life insurance.

Similar figures for pension and retirement benefits are more disparate. According to the BLS data, over 90 percent of all full-time employees in medium and large firms participated in a retirement or capital accumulation plan in 1985. According to the NFIB data, only 43 percent of full-time workers in small firms were plan participants. Moreover, this figure probably represents a maximum. The CPS pension supplement for 1983 indicates that only 26 percent of full time workers in 1983 were covered by a pension plan. The IRS-SBA data match suggests that only 21 percent of firms with fewer than 100 workers took a pension deduction. The NFIB members probably represent small businesses which are relatively stable and, therefore, more likely to provide benefits.

Different types of retirement plans are provided by small and large employers. Among large employers, 80 percent offered a defined benefit plan in 1985 and 41 percent offered a defined contribution plan. Many large and medium-sized employers offered their employees both types of plan. In contrast, defined contribution plans are favored by small employers with 65 percent of the NFIB survey respondents providing retirement benefits indicating that they provided such a plan. And half of these are profit

sharing plans. Only 6 percent of small firms offered a multiemployer plan and 25 percent offered defined benefit plans.

Why Don't Employers Have Pension Plans?

Several related research issues are tied to an assessment of why many small employers do not provide pensions. These research issues include an analysis of why small employers pay lower wages and how pension plans act to increase productivity. Research studies have also considered whether companies can simply substitute wage payments for pension payments in their compensation packages.

Recent findings suggest that pension contributions are not simply a substitute for wages although workers with higher earnings and those in higher tax brackets tend to appreciate some substitution towards tax-deferred compensation. Current research also suggests that wages are higher in large firms because large firms are more difficult to manage efficiently. Pensions are felt to serve a management purpose, in part, by inducing productive workers to stay on the job longer. While researchers do not completely agree about how pensions enhance productivity, there is a consensus that pensions serve an economic purpose.

In general, employers will provide pensions if the benefits from establishing the plan are greater than the costs of the plan. Yet the administrative costs of plans for small employers are likely to be greater than those for large employers. Several studies show that costs per plan participant are smaller for larger pension plans. The 1985 NFIB data indicate that administrative costs range from an average of over \$400 per participant for employers with only 3 to 4 employees to an average of \$76 per participant

for plans with 50 to 99 employees. Presumably, the economic benefits of having a plan would have to be greater for small employers than for large corporations.

Tabulations of the 1983 CPS pension supplement suggest that employees who work for firms with pension plans are different than employees who work for firms without pension plans. For instance, only 3.5 percent of employees working for very small firms and covered by a pension plan work fewer than 500 hours compared to 10 percent of all workers in very small firms without pension coverage. Similarly, 83 percent of workers in very small firms with pension coverage are between age 25 and 65 compared to 65 percent in very small firms without coverage. The average tenure of covered workers in very small firms is about 7.5 years on the job compared to 4.3 years for those without pension coverage. These figures suggest that even small employers find it profitable to provide pensions when their workforce is older, relatively stable and presumably more productive.

In addition, the earnings of workers with pension plans, even when they work for very small employers, are higher than the earnings of those without plans. Average earnings for covered workers in small firms are \$17,100 compared to only \$10,100 for those without coverage. Higher income workers may be more likely to have pension coverage for two reasons. First, they may be more willing to accept deferred compensation because of their higher marginal tax rates. But, employers may also be more willing to pay more productive workers pensions in the hopes of keeping them with the firm longer.

One frequently cited reason for instituting a pension plan is that of firm profitability. Profitability might influence pension coverage for a number of reasons. A profitable firm would be more likely to be in a position to make the type of long-term commitment that a pension plan implies. Furthermore, a

profitable firm might also be a growing firm. The NFIB data base does not have information about profitability but provides information on sales. Statistical analysis indicates that firms with higher sales are uniformly more likely to have a pension plan. (Research on profitability for firms with and without pensions could only be conducted through a special analysis of the SBA's IRS match file.)

Small-Employer Pensions and Public Policy

The data presented suggest that the provision of pensions by employers with 100 or fewer employees is influenced by business considerations. Consequently, public policy options which would reduce the costs providing a plan or increase the benefits of pension plan provision for small employers would encourage pension coverage. Yet another public policy consideration has been to discourage pension plans which are simply established to shelter the income of owner-managers or other highly paid executives and partners. The data suggest that some concern about professional corporations may be warranted as one-third of all employees with pension coverage in firms with 25 or fewer employees work in the professional-service industry. This industrial category only accounts for 23 percent of workers in very small firms without coverage. A similar skew in the industrial distribution for covered and noncovered workers is not observed in other firm-size categories including firms employing 25 to 99 workers.

As in any area of government regulation, concerns about the efficacy of economic incentives should be balanced against the potential for abuse. In this area as others, better facts and figures can be instrumental in achieving that balance.

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Summary of Statement
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In 1983, roughly 44 percent of all nonfarm employees worked for an employer who did not provide a pension plan. The majority of these workers were employed by firms with fewer than 100 employees. This testimony discusses small employer pension coverage using statistics based on several data sources that have been made available recently.

Small firms provide important employment opportunities for much of the population. In total, 46 percent of all civilian nonfarm employees worked for firms with fewer than 100 employees. Small employers may be found in all industries although workers in smaller firms are less likely to work in manufacturing and more likely to work in services.

Because small employers hire workers in occupations which parallel the industries in which they work, the occupational distribution of small firms is different from that of large firms. And large employers are more likely to have unionized workers. Very small firms engage a smaller percentage of prime-age full-time full-year workers. These differences suggest that there may also be differences in their wages and benefits.

One of the most consistent findings of researchers is that small firms pay less than large firms. Workers in small businesses are generally also less likely to receive employee benefits than workers in large businesses. Different types of retirement plans are provided by small and large employers. These differences suggest that economic factors may be important influences on plan provision.

In general, employers will provide pensions if the benefits from establishing the plan are greater than the costs of the plan. Yet the administrative costs of plans for small employers are likely to be greater than those for large employers. Presumably, the economic benefits of having a plan would have to be greater for small employers than for large corporations. And tabulations suggest that employees who work for firms with pension plans are different than employees who work for firms without pension plans.

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Verbal Statement of
Emily S. Andrews, Ph.D.
Research Director
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before the
U.S. Senate
Committee on Finance
Subcommittee on Private Retirement Plans
and
Oversight of the Internal Revenue Service

Good afternoon. I am Emily Andrews, Research Director at the Employee Benefit Research Institute (EBRI). EBRI is a nonprofit, nonpartisan public policy research organization. We attempt to provide information useful to the formation of public policy; we do not take positions on public policy issues.

I am pleased to provide information on pension plan coverage among small employers in the United States. I have submitted written testimony to the Subcommittee, and will summarize the major points of that testimony today.

In 1983, roughly 44 percent of all nonfarm employees worked for an employer who did not provide a pension plan. The majority of these workers were employed by firms with fewer than 100 employees. My testimony discusses small employer pension coverage using statistics based on several data sources that have been made available recently.

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My written testimony provides more statistical information about small employers with and without pension plans. I would be happy to answer any questions you might have about these figures, or other aspects of pension coverage among small employers. And I thank you for the opportunity to appear before the Subcommittee today.