Chapter 02 The Psychology and Economics of Employee Benefits

I. Learning Objectives (use PP 2.2)

1. The employment relationship as an exchange relationship and the psychology behind why firms provide employee benefits
2. Employee benefits as part of the psychological contract and how some employee expectations about benefits might be formed
3. How violations by the organization of employees' expectations can lead to perceptions of injustice
4. The economic rationales for employers to offer a mixture of cash and benefits in a compensation package
5. Why insurance is less costly for larger groups
6. How changes in benefits costs affect employer profits and the amount of cash wages that employers are willing to pay
7. How changes in the value that workers place on their benefits package influence their choices of jobs and acceptable salary ranges

II. The Psychology of Employee Benefits

III. Employment Relationship as Social Exchange (use PP 2.4)

1. Social exchange: All social behavior can be seen as "an exchange of activity (*work effort*), tangible (*visible performance*) or intangible (*motivation and commitment*), and more or less rewarding or costly (*pay and benefits*), between at least two persons (*employee and employer*)". Thus, social exchange in the employer-employee relationship is one in which the employer offers inducements (e.g. wages, employee benefits) in return for employee contributions (e.g. performance, commitment).

A. How employee benefits constitute social exchange (use PP 2.5)

1. For companies, employee benefits not only offer cost advantages and tax incentives, but also act as a recruitment tool for attracting and retaining desired employees.
2. The employment relationship can be said to constitute both economic exchange and social exchange.
   a. Economic exchange, as with wages and salary, is one in which the nature of the exchange has been specified at the time of employment.
   b. Social exchange tends to evolve over the employment period and is not necessarily established at the time of employment.
3. If an employer can provide an employee with benefits suitable to an employee's evolving needs, the employee is likely to reciprocate with increased work effort and commitment. Hence, employee benefits are an especially relevant component of the social exchange between the employer and employee.

B. Workforce changes and the employment relationship (use PP 2.6)

1. Jobs are no longer characterized by traditional job security, strong loyalty to the organization, or the patriarchal role of the organization in the life of the employee. Instead, work arrangements and careers have become more flexible.
2. Apart from economic and market challenges, the workforce in the U.S. and other developed economies is becoming increasingly diverse.

3. Two strong contingencies are shaping the employment relationship in terms of employee benefits today. The first is the economic challenges faced by the company. The second is the changing composition of the workforce. Both of these will determine the emerging role of employee benefits practices in the social exchange relationship between employers and employees.

IV. Psychological Contracts

***A. Overview* (use PP 2.7)**

1. A psychological contract has been defined as an employee's subjective perceptions of the relationship of mutual obligations with the employer/company.
2. Employee benefits can be a part of the psychological contract that employees hold about the employer's obligations to them in exchange for their work efforts.
3. Psychological contracts result in employees holding a range or continuum of expectations from the employer, ranging from pay and promotions to career development and family welfare.
4. The continuum of expectations that employees hold from an employer can be seen as ranging between two ends: transactional psychological contracts and relational psychological contracts (see Table 2.2) (use PP 2.8)
    a. Toward the transactional end of the continuum, employees' expectations from the employer are more economic and extrinsic in nature. Thus, employees' expectations of high pay and promotions or career advancement in exchange for hard work represent transactional types of expectations in the psychological contract.
    b. On the other hand, toward the relational end of employees' expectations from the employer that might be either economic or non-economic, but they are also emotional, subjective, and intrinsic in nature. Thus, employees' expectations of job security in exchange for loyalty to the employer represent relational types of expectations in the psychological contract.
5. Employee benefits practices can be seen to fulfill both transactional and relational expectations of employees (see Exhibit 2.1) (use PP 2.9)
    a. Health insurance and other legally required benefits would form a part of employees' transactional expectations from the employer.
    b. Employee benefits such as the paid time off and accommodation and enhancement benefits examined in the previous chapter might help fulfill employees' relational expectations.
    c. Retirement plans is a good example of employee benefits that fulfill both transactional and relational expectations; similarly, educational assistance benefits aimed at rewarding continued employment as well as career development would help fulfill both transactional and relational expectations.

B. Psychological contract development

1. Most psychological contracts take shape in the pre-employment phase, when people seek information during recruitment and selection. Employees might seek information about both transactional and relational expectations from their potential employer. (use PP 2.10)

2. Ultimately, what an employee learns about employer's benefits practices will form a part of the employee's expectations from this exchange relationship along this transactional-relational continuum.
3. Employees can form expectations that comprise their psychological contracts from two sources: their interactions with other members of the company and their perceptions of the company's culture. (use PP 2.11)
4. Psychological contracts are flexible in nature, undergoing constant change based on the interactions employees have with the company and with other employees. This flexibility allows employees to adapt to changes in the company's practices. (use PP 2.12)
    a. If employees hold relatively stable expectations from employers, any changes in the policies and practices of the company will lead to the employee feeling betrayed unless changes entail offering more rather less.
    b. However, if the employees have flexible expectations, they are more likely to change their psychological contracts to adjust for the changes the employer is compelled to make.

C. *Psychological contract violation* (use PP 2.13)

1. A violation of the psychological contract occurs when an employee perceives a discrepancy between the promises made by the employer and the actual fulfillment of the promises.
2. If a company withdraws or changes certain benefits, and those practices constituted an employee's psychological expectations from the company, then the employee will feel that the contract has been violated.
3. Violations of psychological contracts are different from unmet expectations. The responses to the violation of psychological contracts are likely to be more intense. Violation of employees' expectations by the employer can cause feelings of betrayal and loss of trust.
4. There may be two basic causes for violations of psychological contracts: reneging and incongruence.
    a. When a company deliberately breaks a promise to employees, either willingly or because of circumstances, reneging is said to occur.
    b. Incongruence occurs when the employee and the employer have different conceptualizations of the employment relationship.

D. Employee benefits as constituting psychological contracts

1. If employee benefits are a part of employees' psychological contract, then it is important for employers to ensure that employee expectations about benefits are clearly articulated and flexible.
2. Violations can be avoided by clear communication and education about the nature and scope of the employee benefits practices offered by the company.
3. Just as employees have expectations from the employer, the employer is also likely to have expectations from the employee.
4. If the organization feels that employee performance is not what is expected, it can decide to withhold certain employee benefits, especially discretionary benefits.
5. Employee benefits have, over the years, become a growing source of employees' psychological contract violations.

a. Expectations about employees' cost burden, needs, and benefits design will all affect employee satisfaction.

V. The Economics of Employee Benefits

VI. Why Do Employers Offer Benefits

A. 3 Primary Reasons **(use PP 2.15)**

1. Cost advantage for employer
2. It helps in recruiting certain types of workers
3. Tax incentives

B. Cost Advantages **(use PP 2.16)**

1. Benefits, like health insurance are cheaper for the employer to purchase for a group than employees can purchase individually
2. EXAMPLE: Health insurance costs $1000 per employee, if purchased by employer that employs 500. Individually, the same policy would cost each employee $2500. Employees better off if pay is reduced less that $2500. Employer benefits if they deduct more than $1000 to provide insurance.
3. Reasons why group insurance rates decrease as group size increases
    a. Insurance becomes less risky to provide
    b. The fear of high-risk policyholders driving out the low-risk ones is reduced
    c. The administrative cost per employee is reduced, referred to as *economies of scale*
    d. It is easier for insurance companies to predict the total medical expenses
4. Individual policyholders and small groups of policyholders may have to undergo *medical underwriting*
    a. Policy holders fill out a questionnaire about their medical history
    b. Insurance companies require because the policies are riskier to write
5. The larger the group the less likelihood of *adverse selection*
    a. The condition where the insurance pool attracts only high-risk individuals
    b. Requires all employees to participate in insurance pool
    c. Is used as a justification for government-provided insurance programs, like
        i. Social Security
        ii. Medicare
        iii. Workers' Compensation
6. Experience *ratings*, information from medical underwriting, determine policyholders' risk profile and policy rates (use PP 2.19)

C. Recruiting Certain Types of Workers **(use PP 2.21)**

1. The larger the group the less likelihood of *adverse selection*
2. Recent undergraduates might be attracted to a tuition reimbursement benefit
3. Women 20-40 might be interested in company-paid health insurance
4. Older workers might be attracted to stronger retirement plans
5. Tailoring packages might have unintended consequences, like
    a. Offering strong mental health or substance abuse benefits might attract substance abusers

  b. (not in book) Attracting older workers with strong retirement benefits, might increase health insurance costs
  c. (not in book) Attracting younger women might increase the need for replacement workers due to maternity leaves and FMLA time off

D. Tax Incentives **(use PP 2.22)**

1. Mainly from the IRC
2. IRC allows companies to deduct some benefits as business expenses (more in chapter 3)
3. IRC does not tax some benefits as income to employees
4. EXAMPLE: *Employee at 25% tax rate. If company raises the employee's salary by $1000, the IRC would get $250 of it. If company gives the employee a health insurance plan that costs $1000, employee receives total benefit without being taxed. To buy a $1000 policy, employee would have to earn $1333.33 pretax to pay for it.*
5. Retirement plans are driven by generous tax treatments

E. Requirements to Make the Benefits Attractive

1. Employers need to figure out the cash value that employees place on particular benefits
2. Employers need to discover which benefits employees prefer
3. Employees have to be willing to give up wages/salary to receive benefits

VII. Who Pays for Benefits?

A. Employee or Employer **(use PP 2.24)**

1. Employees used to view benefits as "free add-ons"
2. Greatest portion of all employee benefits are paid by employees by
   a. Lower wages/salary
   b. Lower bonuses
3. Company profits are seldom affected directly by higher benefits costs

B. Passing on Higher Costs Resulting in Lower Wages Depends on **(use PP 2.24)**

1. The cash value that employees place on the benefit.
   a. EXAMPLE: *Employees have 2 options; a $90,000 salary with no health insurance or $75,000 and a comprehensive fee-for-service health plan. Those who might use the plan more, might need expensive health services, or are more adverse to risk taking might take the lower pay and benefit. The healthy, young, and ones with partners who have them covered under their health plan might take the higher wage and no health plan. In other words, is the health plan worth the $15000?*
   b. EXAMPLE: *What if the insurance carrier raises costs for health insurance by 10%. The company could reduce pay increases from 5% to 3% to cover the costs. Would employees accept the reduction?*
2. The degree to which employers will increase /decrease their hiring when the market compensation level decreases/increases; and the degree to which employees will change their desire to work when the market compensation package changes.

  a. EXAMPLE: *If an employer wants to add a $10,000 (per employee per year) health plan to employees salary of $100,000. Employers could assume the cost, which would reduce profits of $10,000 per employee per year, or reduce pay by $10,000. Could the company assume the cut in profits and still afford to keep their employees or hire new ones? Would the $90,000 salary attract the right workforce?*
3. Whether the benefit cost increases for all employers in the market, or for a specific employer.
4. Whether the hiring decisions of a particular employer affect the market compensation level.

C. Reasons Why Health Insurance Costs Might Rise **(use PP 2.25)**

1. The rise reflects a general improvement in medical care technology and health care quality, but also more expensive technology.
2. Legal changes allow doctors to unionize and thereby charge higher prices for the existing services they provide.
3. Health insurance costs rose by 10% at only this employer because the company workforce is a year older and is at an increased likelihood of contracting additional medical conditions and hence generating additional medical costs.
4. Health insurance costs rose by 10% at only this employer because the employer decided to layoff a significant portion of their employees, thereby reducing the size of the insured group

D. Indications

1. Employees see #1 & #3 as adding value to their insurance
2. Employees believe that #2 & #4 do NOT add value to their insurance
3. #1 & #2 would affect all employers
4. #3 & #4 are specific to a particular employer, not the entire industry
5. Income will tend to fall when health insurance cost increases are derived from improved quality #1, or when there will be an increased use among employees #3
6. When the increases are not seen as adding value to the insurance, employers may NOT be able to pass the increases along to the employees
7. The increases may NOT be passed along depending on
   a. Whether the insurance costs rise for this particular employer or all employers in the market
   b. The degree to which workers and employers will change their labor demand and supply when compensation costs change
8. EXAMPLE: *To hire a high quality lawyer a company would have to pay at least $100,000. An employer might be able to pay $80,000 and offer a health insurance benefit valued at $20,000. If the insurance company raised the costs by $5000 per employee, would the package still attract quality employees if the cost is passed along to the employees?*
9. If workers are willing to leave the workforce when compensation levels fall, and employers have relatively inflexible staffing needs, employees will tend to pay for benefit cost increases
10. If the benefit cost increases affect all employers in a specific market, employees will probably NOT change their employment status

a. Especially for prime-age (30 to 54) male workers
b. NOT as common among women with children, the elderly, part-time workers, and young workers

E. Who Pays

1. Most workers with employer-sponsored health insurance pay a token monthly contribution towards their insurance premium
2. According to data from the 2011 National Compensation Survey
   a. Most employees were required to make contribution make a contribution toward their health insurance cost.
   b. The typical monthly contribution was ranged between $32.50 to $127.74 for single coverage
   c. The typical monthly contribution ranged between $126.00 to $768.87 for family coverage
   d. Monthly premiums are usually paid for out of after-tax income
   e. Employee contributions were only a small portion of the total insurance costs
   f. Most employers' contributions actually comes from lowering employee wages or salary
3. The monthly contributions allow employers to charge employees different rates, depending on insurance needs, like
   a. Family size
   b. Different levels of coverage
4. Monthly contributions make it easier for employers to pass along benefit cost increases to employees
5. Instead of lowering income employers may also
   a. Scale back a scheduled bonus
   b. Reduce the yearly income increase
   c. Hire new workers at a lower income level

Summary

This chapter discusses two important issues. First, psychological basis of employee benefits are examined from the employee's perspective. Employee benefits practices can fulfill employees' transactional and relational expectations from the employer and employment exchange relationship. If employees view their employer's benefit program as fair and meeting their expectations, then those employees will be satisfied and productive. Second, economics of employee benefits are examined from the perspective of the employer. This section of the chapter explored why many employers offer a mixture of cash and benefits in compensation packages and whether workers tend to pay for benefit cost increases in the form of lower cash wages.

Discussion Questions

1. Discuss the concept of social exchange as it relates to the employment relationship. How does this concept apply to employee-benefits practices?

Main Points

- Employment relationship consists of clusters of human resource practices offered to a group of employees along with the resulting employee contributions to the employer.
- Social exchange in the employer-employee relationship is one where the employer offers inducements (e.g., employee benefits) in return for employee contributions (e.g., performance).
- If an employer can provide an employee with benefits suitable to the employee's evolving needs, the employee is likely to reciprocate with increased work effort and commitment. Therefore, employee benefits are an especially relevant component of the social exchange between the employer and employee.

2. Discuss how changes in the demographic composition of the U.S. workforce will affect the employment relationship from an employer's perspective. What possible impact will these changes have on employee-benefits practices?

Main Points

- The workforce in America is becoming increasingly diverse.
- The benefit practices were designed for mostly white, married male workforce, typically from a single-earner household. Because of the changing demographics, companies can no longer afford to do so.
- Employee benefit practices should reflect the needs and expectations of the changing composition of the workforce.

3. What are psychological contracts? Discuss the main features of psychological contracts and how they develop.

Main Points

- A psychological contract has been defined as an employee's subjective perception of the relationship of mutual obligations with the employer and company.
- Psychological contracts result in employees holding a range or continuum of expectations from the employer, ranging from pay and promotions to career development and family welfare.
- The continuum of expectations have two ends: transactional psychological contracts and relational psychological contracts.

- Toward the transactional end, employees' expectations are more economic and extrinsic in nature. On the other hand, toward the relational end, employees' expectations might be either economic or non-economic, but are also emotional, subjective, and intrinsic in nature.
- Most psychological contracts take shape in the pre-employment phase, when people seek information during recruitment and selection.
- Employees can form expectations that comprise their psychological contracts from two sources: their interactions with other members and their perceptions of the company's culture.
- Psychological contracts are flexible, undergoing constant change based on the interactions.

4. How do employee benefits form a part of employees' psychological contracts? Discuss how employees' psychological contracts might be violated and the consequences of these violations for employers.

Main Points

- Employee benefits can be a part of the psychological contract employees hold about the employer's obligations to them in exchange for their efforts. Employee benefit practices can be seen to fulfill both transactional and relational expectations. Employees might expect to receive health insurance in addition to wages (more transactional). Employee benefits such as paid time-off and accommodation and enhancement benefits might help fulfill the relational expectations. Educational assistance and retirement could fulfill both transactional and relational expectations.
- A violation of the psychological contract occurs when the employee perceives a discrepancy between the promises made by the employer and the actual fulfillment of the promises. Two basic causes for violations: 1) reneging, and 2) incongruence. Reneging occurs when a company deliberately breaks a promise to employees. Incongruence occurs when the employee and the employer have different conceptualizations of the employment relationship. Violations of employees' expectations by the employer can cause feelings of betrayal and loss of trust. Some of the main effects of contract violation can be intentions to leave, actual turnover, low commitment, dissatisfaction, and bad citizenship. Violations of employees' psychological contracts can be quite expensive for employers.

5. One reason employers offer benefits is that the benefits may be cheaper for the employers to provide than it would be for the employees to purchase on their own. Besides the insurance examples discussed in this chapter, what other benefits are cheaper for employers to provide than for individuals to purchase on their own? Even if a particular benefit is cheaper for an employer to provide, would that employer always want to provide it as part of a compensation package? Why or why not?

Main Points

- Student answers will vary.
- Retirement annuities and disability and life insurance are other leading examples of benefits that tend to be cheaper when purchased as part of a large group.
- Even if a particular benefit is cheaper for an employer to provide, employers would not always want to provide it as part of a compensation package for variety or reasons. For instance, offering mental health services or substance abuse treatment might be cheaper for the employer to purchase similar to health insurance plans. However, the employer might also find that the types of employees who are most likely to accept a position, or most likely to stay at the employer, are those suffering from these conditions. Employers would like to attract and retain certain types of employees and therefore, they would want to design their benefit packages based the needs and preferences of their current and potential employees. It does not make sense for the employer to provide benefits just because they can purchase it cheaper.

6. One reason employers might offer a particular employee benefit is to aid in recruiting certain types of workers. One example given in this chapter is a tuition reimbursement program to attract highly motivated employees. What other examples of benefits are you familiar with that might be used to attract a particular type of employee? What types of employees are most attracted to these benefits?

Main Points

- Student answers will vary.
- For example, to attract unmarried younger employees for jobs that require extensive traveling, employers might offer better vacation packages, memberships for physical fitness activities, and educational benefits.

7. Small employers are less likely than large employers to offer health insurance to their employees. One reason for this is that health insurance tends to cost more for small employers than for large employers. Explain why health insurance costs more for smaller insurance pools. What public policies are currently being proposed to remedy the disparity in health insurance coverage between small and large employers?

Main Points

- As the group gets larger, insurance becomes less risky to provide. So, smaller groups face higher insurance costs to compensate insurance companies for the added risk they bear.
- For smaller insurance pools, insurance companies need to worry more about the phenomenon of high-risk individuals driving out low-risk individuals.
- As the group gets larger, fixed administrative costs can be spread out among more people. In smaller insurance pools, administrative costs per employee will be higher compared to larger pools.
- Student answers will change depending on their search. One example can be “Small business health care tax credit” which is one of the tax provisions of Affordable Care Act

8. A major theme of this chapter is that employers need to know the dollar value that employees place on benefits. Explain concisely why this type of information is important for employers to have. What methods do employers actually use to gauge their employees' valuation of benefit packages?

Main Points

- The greater value employees place on a benefit, the larger reduction in cash wages they will accept if the benefit is introduced into a compensation package.
- For instance, an employer can understand their employees' valuation of benefit packages by offering two choices for a newly hired employee. In the first choice, let's say the employer provides $75,000 annual salary plus a comprehensive health care plan, and as a second choice the employer offers a $90,000 annual salary without a health care plan. Those who tend to use health services more frequently and more risk averse will tend to place a relatively higher value on the health insurance plan, and are therefore, more likely to forgo the extra $15,000 in salary. On the other hand, healthier people and those willing to bear more financial risk are more likely to choose the extra salary.
- Similarly, if the choice was between a $75,000 salary plus the health plan vs $100,000 salary and no health plan some employees who would have opted for the health insurance in the first situation would now choose the higher salary instead. Here, employees prefer $25,000 in cash to health insurance provided by the employer.
- This type of decisions of employees helps employers to understand their employees' valuation of benefit packages.

Cases

Understanding Your Benefits

Forgoing a Benefits Package

1. Why would a company offer salary with no benefits?
2. Do you think the offer without benefits is worth pursuing?

Instructor Notes

Employers offer benefits to employees for many reasons. An employer is able to offer benefits such as health insurance at a lower cost than if the employee would purchase the benefit on his or her own, and thus the benefit becomes of more value in the compensation package. Employee benefits can also attract certain kinds of workers and offers tax incentives for employers. As most employers now offer benefits such as health insurance and a retirement savings plan, an employer will also consider competitor offerings when establishing a benefit plan. For these reasons, benefits can offer a different value in the total compensation offered to an employee.

Student Responses

1. Why would a company offer salary with no benefits?

Few companies offer no benefits such as in this case, but there may be a variety of reasons why a company does not offer benefits. Often start-up companies can't afford to offer certain benefits or may have an uncertain future. If you consider that a company may use benefits to recruit certain kinds of workers, it may be a concern that the company does not offer any benefits. What kind of worker does not want health insurance or retirement benefits? That is concerning. Perhaps the company is looking for short-term employees for some reason. It is important to fully understand the company and the job you are looking at as you consider the compensation offered.

2. Do you think the offer without benefits is worth pursuing?

It may be risky to take a position without benefits. While you could seek an independent health insurance option, you don't have the same buying power as an organization with a lot of employees and thus you may not be able to find an insurance plan that is affordable. Further, while you can have good intentions to set aside money for retirement, often it is easy to slip behind. If you have cash coming in your pay instead, you may decide to spend the money on a current need as opposed to saving for retirement which is a far off need.

Cutting Benefits at Generals Construction

1. Does Jane have a valid concern?
2. What kind of changes could the company make to benefits to address Jane's concerns?

Instructor Notes

When designing benefit plans, organizations are challenged to balance economic needs with the expectations of employees. In this case, based on the psychological contract that the employees have with the company, these cuts could make the employees feel that their expectations were violated. Such cuts are particularly challenging when the company is doing well financially. It will be difficult for workers to understand the need of such cuts. Newer companies often make decisions about benefit offerings without taking a long-term outlook. Creating a generous benefit package can attract needed workers, but employers should be cautious and only offer benefits they can sustain.

Student Responses

1. Does Jane have a valid concern?

Yes, Jane does have a valid concern. Generals Construction has a psychological contract with its employees regarding their benefits. During the hiring process, and over the first ten years, the employer offered a generous benefit package to attract and retain employees. In turn, the employees expected those benefits to be a continuing part of the employment relationship. A violation of the psychological contract occurs when there is a discrepancy between what was promised and the actual fulfillment of those expectations. While the employer likely did not have a written contract promising the continuation of the benefits, the fact that they were offered for ten years suggests to the employees that they will continue. This is particularly true as the company is continuing to succeed and grow. Now that the company is stable, the employees will react negatively to such a cut in benefits. They are likely to feel betrayed and distrustful. They might be willing to accept the changes if the company was in a downturn. Further, cutting the benefits of the construction workers and not the others is likely to have an even more problematic effect on company morale.

2. What kind of changes could the company make to benefits to address Jane's concerns?

The employees in this case may have an unrealistic expectation of what the company should provide them, but that expectation was established based on the company providing them the benefits consistently over an extended period of time. If the company wants to shift employee expectations, it needs to do so gradually as well. Shifting some of the burden of the cost of health care insurance to employees would not be entirely unacceptable. However, those changes should be more gradually. It would be wise to begin with giving a smaller portion of the premium to the employees. While they might charge a little more for employees who have coverage for their full family, they should not cut their support entirely. Further, cutting a vacation benefit that the employees have grown accustom to having is not something that the employees will accept readily. The company could change the new hire vacation allowance, however, the negative impact of cutting only the construction worker vacation would likely result in the loss of workers. Jane should take some time to review all benefits offered by the company to understand utilization rates. For example, if the company offers vision insurance and only a few employees use it, they could consider cutting the vision insurance. They could also examine expenses in other areas of employee management that they could cut.