2. Employee benefits as part of the psychological contract and how some employee expectations about benefits might be formed.
3. How employee perceptions of justice or fairness are important to understanding how pay and benefits practices influence employee attitudes.
4. The economic rationales for why companies offer employee benefits.
5. Who pays for employee benefits.

The purpose of this chapter is twofold. First, it is important to learn about the *psychological* basis of employee benefits. Employers can use this knowledge to understand how employee benefits influence the attitudes and performance of their employees. Also, employers can then develop and maintain effective benefits programs aimed at promoting worker satisfaction, commitment, and productivity.

Second, it is important to understand the *economic* basis of employee benefits. Employee benefits are a costly proposition. Even though employee benefits are expensive, most employers continue to offer them. Still, it begs the question pertaining to whether companies should have workers pay for life or disability insurance. After considering the psychology of employee benefits, we will take up topics about the economics of employee benefits.

THE PSYCHOLOGY OF EMPLOYEE BENEFITS

This discussion of the psychology of employee benefits is organized into three sections. First, the employment relationship as social exchange is considered. Second, psychological contracts are discussed. Third, we look at the relationship between having a benefits program and employee attitudes.

Employment Relationship as Social Exchange

Most voluntary human behaviors are driven, in part, by some expectation of outcomes. Work behaviors are no exception. In fact, work behaviors are some of the most deliberated and goal-directed behaviors. In the most general terms, the employment relationship consists of clusters of human resource practices offered to a group of employees along with the resulting employee contributions to the employer.[1]

The basis for understanding the employment relationship lies in the concept of **social exchange**—the most basic concept explaining social behavior. 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 e-mplo^yer)!'*[1] 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).[3]

How Employee Benefits Constitute Social Exchange

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. Employee benefits provide employees with economic and income security, and also with personal and family welfare. People choose to work in exchange for remuneration. While wages or salary act as basic remuneration, employee benefits act as remuneration for the welfare of employees and fulfill such needs as health care, dependent care, retirement planning, vacations, and education. As such, in exchange, they elicit increased motivation and commitment from employees toward the company and its goals.

The employment relationship can be said to constitute both economic exchange and social exchange.[4] **Economic exchange**, as with wages and salary, is one in which the nature of the exchange has been specified at the time of employment. (Of course, economic exchange can also be renegotiated at any time during employment, as with yearly pay raises). Explicit company policies and procedures help to ensure that each party (i.e., the employer and the employee) fulfills the obligations in the exchange relationship. In other words, in exchange for continued employment and wages, employees are obligated to work for the employer. Certain employee benefits can fall under the category of economic exchange. For example, health insurance can be viewed in monetary terms, since it costs employers to pay for employees to have health insurance and is usually a part of the explicit agreement at the time of employment.

Social exchange tends to evolve over the employment period and is not necessarily established at the time of employment. The nature of the social exchange is left to the discretion of the employer and employee. As employees become aware of policies or use various employer practices over the period of their employment, they reciprocate with increased or decreased job effort and commitment. Employee-benefits practices are numerous and versatile, as indicated by the range and variety of practices presented in Chapter 1. Employees' needs change over the duration of their employment with a company. This change may be in terms of personal career needs or self, family health, and welfare needs. Different employee benefits are likely to be relevant to employees at different circumstances and stages of their lives and careers. 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.

Workforce Changes and the Employment Relationship

To understand the importance of employee benefits for both employees and employers, it is important to understand the dynamic nature of the employment relationship. The nature of the employment relationship, especially in developed economies, has undergone several changes over the past few decades. 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. There has been an increase in part-time and contingent workers. Regular layoffs have been taking place, especially in certain industries, such as manufacturing.

From economic and market challenges, the workforce in the United States and other developed economies is becoming increasingly diverse. Diversity in the workforce is stemming from an aging population[5] poised on the brink of retirement,[6] increased labor force participation by those over the age of 60,[7] decreasing age cohorts,[8] an increase in the proportion of racial and ethnic minorities and immigrants,[9] and an increase in single-person households.[10] Some of these trends and projections for the future are presented in Exhibit 2.1.

Traditionally, the design of compensation and benefits packages had assumed a similarity among employees of attitudes, needs, and expectations, particularly on a white, married, male workforce from a single-earner household. Exhibit 2.1 illustrates the expected changes in workforce demographics through 2024. Through the decades, employees developed a strong entitlement mentality. Until recently, employers did little to manage these expectations. Nowadays, companies are shifting some of the costs of benefits to employers, with one example being higher contributions for

EXHIBIT 2.1
Civilian Labor Force by Age, Gender, Race, and Ethnicity for 1994, 2014, and Projected to 2024

Source: Labor Force Projections to 2024: The Labor Force Is Growing, But Slowly Monthly Labor Review

	Percent Change		
Group	**1994-2004**	**2004-2014**	**2014-2024**
Total, 16 years and older	12.5	5.8	5.0
Age, years			
16-24	3.0	-4.4	-13.1
25-54	8.8	-1.3	3.9
55 and older	48.0	47.1	19.8
Gender			
Men	11.5	4.9	4.4
Women	13.6	6.7	5.8
Race			
White	9.0	1.9	2.3
Black	14.7	13.4	10.1
Asian	14.6	39.7	23.2
All other groups	-	45.7	22.2
Ethnicity			
Hispanic origin	60.9	31.6	28.0
Other than Hispanic origin	7.6	1.9	0.6
White non-Hispanic	2.7	-2.5	-3.0

health-care coverage. These dynamics can be better understood by becoming familiar with the role of economic challenges facing companies and changing workforce demographics. Both of these will determine the emerging role of employee-benefits practices in the social exchange relationship between employers and employees.

The cost of benefits surely is noteworthy, with companies often spending about 30 percent of the total compensation budget on employee benefits. Companies stand to miss opportunities to promote employee satisfaction, commitment, and productivity unless the set of employee benefits is placed in the context of the psychological contract. We now will learn about some well-established psychological concepts relevant for explaining the importance, role, and impact of employee benefits for employees and employers.

PSYCHOLOGICAL CONTRACTS

Psychological contracts are an articulation of the exchange relationship between the employer and the employee. A *psychological contract* has been defined as an employee's subjective perceptions of the relationship of mutual obligations with the employer and company.[11] 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. (Similarly, employers can expect employees to work and be committed to the company in exchange for the benefits they provide.)

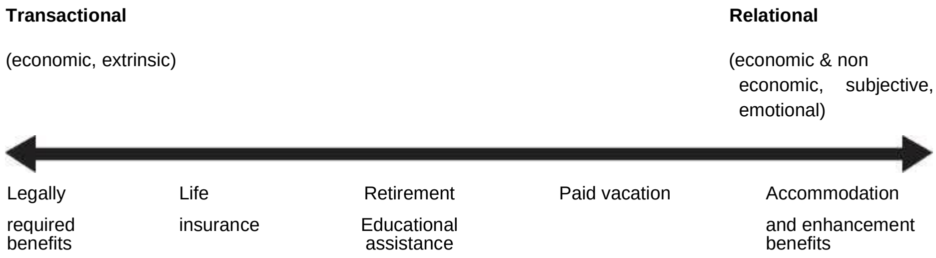
Psychological contracts *implicitly* establish terms of employment, which stands in contrast to exchange agreements, such as wage and salary levels. As an example, company policies might imply that an employee will be eligible for educational assistance after five years of continuous employment and satisfactory levels of performance. An employee who is interested in making use of this benefit would reciprocate by remaining with the company and working hard. The employee's psychological contract with the company would include the employee's obligations (five years of hard work) and the employer's obligations (educational assistance). Psychological contracts are not an either-or proposition. Expectations of the employer fall on a conin- uum, ranging from pay and promotions to career development and family welfare.

Exhibit 2.2 illustrates the continuum of expectations encompassed between **transactional psychological contracts** and **relational psychological contracts.** Toward the transactional end of the continuum, employees' expectations of the employer are more economic and extrinsic in nature, which translate to expectations of high pay and promotions or career advancement in exchange for hard work represent transactional types of expectations in the psychological contract. Toward the relational end, employees' expectations might focus on either economic or noneconomic, and these expectations are emotional, subjective, and intrinsic in nature. Employees' expectations of job security in exchange for loyalty to the employer represent relational types of expectations in the psychological contract.

Transactional psychological contracts can be understood with an example of short-term employment. An independent contractor or consultant hired by a firm is more likely to have transactional expectations of the hiring firm. The

EXHIBIT 2.2

Transactional-Relational Continuum of Employee Expectations (Employee Benefits as Examples)



independent consultant or contractor would expect the firm to provide good pay, as well as the opportunity to build his or her marketability by adding the firm to his or her client portfolio. Once the project or assignment for which the independent contractor was hired is completed, the exchange relationship with the firm might end. Relational expectations can be understood by looking at the employee- employer relationship. Employees hired by a company or firm with the understanding of full-time employment are more likely to hold both transactional and relational expectations of their employer. For instance, not only will such employees expect pay, promotion, and career advancement in exchange for work efforts, but also they will expect job security, recognition, and support in exchange for commitment and loyalty to the employer. The main features of the continuum of expectations in psychological contracts can be summarized in Exhibit 2.3.

Employee-benefits practices could fulfill both transactional and relational expectations. Some employee benefits might fulfill more transactional expectations. For example, as suggested earlier, U.S. employees might expect employers to provide life and disability insurance in addition to competitive wages. Legally required benefits are a part of employees' transactional expectations of the employer. Employee benefits such as the paid time-off and accommodation and enhancement benefits examined might help fulfill employees' relational expectations. An employee might expect longer paid vacation as their tenure increases or educational assistance such as scholarships for their children.

Additionally, some employee benefits might fulfill both transactional and relational expectations of employees, such as retirement plans. For instance, employees might expect the employer to increase matching contributions as organizational

EXHIBIT 2.3

Psychological Contract Continuum

Source: D. M. Rousseau, "New Hire Perceptions of Their Own and Their Employer's Obligations: A Study of Psychological Contracts," 11

	Transactional Contract	**Relational Contract**
Focus	Economic, extrinsic	Economic and noneconomic, Socio-emotional, intrinsic
Time frame	Closed-ended, specific	Open-ended, indefinite
Stability	Static	Dynamic
Scope	Narrow	Pervasive
Tangibility	Public, observable	Subjective, understood

tenure increases. This would increase their sense of security from the employment relationship. Similarly, educational assistance benefits aimed at rewarding continued employment as well as career development would help fulfill both transactional and relational expectations. Exhibit 2.2 presents the transactional-relational continuum of employee expectations in the exchange relationship with some examples of employee benefits.

Psychological contracts usually change over time. If employees have unrealistic expectations of the employer, they are likely to anticipate that the employer will fulfill obligations that may be beyond the employer's scope. For instance, a sense of entitlement might lead employees to expect a company to provide them with certain employee benefits. However, the company might eliminate the matching contribution to retirement plans or substantially raise the employee contribution for health-care coverage. In such instances, companies should keep employees apprised of the changes on a timely basis. If employee benefits are understood to be a part of employees' psychological contracts, then communication and education about the employee-benefits practices of the company is critical in establishing reasonable employee expectations. These approaches to benefits communications will be discussed in Chapter 10.

Psychological Contract Development

Most psychological contracts take shape in the pre-employment phase, when people seek information during recruitment and after receiving a job offer. Employees might seek information about both transactional and relational expectations of their potential employer. For instance, employees might address their transactional expectations by seeking information about a company's health coverage plan and promotion policies before accepting employment. In addition, they might address their relational expectations by seeking more information about the company's employee assistance or family welfare policies. Ultimately, the knowledge gained will help shape expectations along this transactional-relational continuum.

Through direct inquiry, monitoring, and negotiation, employees may gather information from various sources in the company about these issues. It is expected that, over time, the expectations of the employee and employer will match.[12] Employees can form expectations from two sources: interactions with other members of the company, and their perceptions of the company's culture.[13] If either source is inaccurate, employees might form unrealistic expectations.

Psychological contracts are flexible in nature,[14] undergoing constant change based on interactions with the company and other employees. This flexibility allows employees to adapt to changes in the company's practices. If employees hold relatively stable expectations, any changes in the policies and practices will lead to the employees' feeling betrayed unless changes entail offering more rather than less.

Psychological Contract Violation

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.[15] If a company withdraws or changes certain benefits, and those practices are an employee's psychological expectation of the company, then that employee will feel that the contract has been violated.

Violations of psychological contracts differ from unmet expectations. The responses to the violation of psychological contracts are likely to be more intense.[16] Violation of employees' expectations can cause feelings of betrayal and the onset of mistrust. There may be two basic causes for violations of psychological contracts: reneging and incongruence.[17] When a company deliberately breaks a promise to employees, either willingly or because of circumstances, reneging is said to occur. Incongruence violations occur when the employee and the employer have different conceptualizations of the employment relationship. In other words, the employee might hold certain expectations of the employer. However, if the employee's actual experiences are different from these expectations, then the employee will feel that the psychological contract has been violated.[18]

Employee Benefits as Constituting Psychological Contracts

If employee benefits are a part of employees' psychological contracts, then it is important for employers to ensure that employee expectations about benefits are clearly articulated and flexible. This will allow employers to avoid any psychological contract violations and the associated costs (lawsuits, lost trust, low morale, turnover, etc.). Sometimes, employees may not be affected by minor contract violations. In the course of adjusting to the work environment, employees might also overlook certain violations. However, any serious violations can be avoided by clear communication and education about the nature and scope of the employee-benefits practices offered by the company. For instance, a company with a large Spanish-speaking workforce might be well served by providing information about its benefits practices in both English and Spanish. Companies also can hold training sessions where explanations of the design and eligibility requirements are explained. This will allow employees to form clear and accurate expectations about employee benefits as part of their psychological contracts.

Just as employees have expectations of the employer, the employer is also likely to have expectations of the employee. Incomplete effort, bad citizenship behavior, voluntary turnover, and low motivation can all be perceived by an organization as breaches of contract by the employee. The actions of the employee might also in some way contribute to the violations by the organization.[19] Thus, if the organization feels that employee performance is not what is expected, it can decide to withhold certain employee benefits, especially discretionary benefits. Once again, effective communication on the part of the organization could ensure that the psychological contract consists of explicit, rather than implicit, promises.[20]

Employee benefits have, over the years, become a growing source of employees' psychological contract violations.[21] Earlier, we stated that employers are shifting some of the costs for employee benefits to employees. As benefits costs increase, especially health-care costs, an increasing number of companies are shifting benefits costs to their employees. As the employee cost burden associated with benefits increases, particularly when wages become stagnant, employee satisfaction decreases.[22] Additionally, how benefits are administered is also important. Employees will likely perceive a benefit as unfair if they are not receiving it according to either their needs or perceptions of entitlement.[23] Thus, expectations about employees' cost burden, needs, and benefits design will all affect employee satisfaction. While some benefits may not be the most cost-effective way to meet employee needs, to avoid perceptions of psychological contract violations, companies will need to find lower-priced alternatives without sacrificing employee satisfaction.[24]

EMPLOYEE ATTITUDES AND EMPLOYEE BENEFITS

As discussed earlier, employment can be implicit, such as psychological contracts, and explicit, such as documented in a job offer letter or employment handbook. Employee benefits can be a part of both, with some benefits likely to be more explicitly offered while others are more implicitly available. Congruence between employees' and the employer's expectations will lead to greater fit between the employee and the employer as well as a sense of fairness. Violations of contracts will lead to perceptions of injustice.

Justice and Perceived Organizational Support

The concept of justice is concerned with the distribution of conditions and goods that affect individual well-being. In a work setting, the distribution of rewards (such as pay and benefits), information, and other resources will all lead to perceptions of justice. Perceptions of justice may be based on the rules by which distributions are made, the way rules are implemented, or the way decisions are made. The basis on which employees are eligible for benefits, the value of those benefits, how the benefits are administered, and employer decisions about which benefits to offer to employees would all influence employees' justice perceptions.

There are four types of justice perceptions. **Distributive justice** is perceived fairness about how rewards are distributed; **procedural justice** is the perceived fairness of processes; **informational justice** is the fairness of the accounts given for certain procedures; and **interpersonal justice** is perceived fairness of the interpersonal treatment people receive from others.[25] Job satisfaction, organizational commitment, evaluation of authority, organizational citizenship behavior, withdrawal, and performance are all affected by employees' perceptions of justice along these dimensions.[26]

Distributive justice is employees' perceptions of fairness of the outcomes they receive.[27] Where employee benefits are concerned, employees will form perceptions of fairness based on the benefits they are eligible for. If employees believe that the employer should provide them with certain benefits in exchange for their work efforts, and the employer fails to do so, then employees will conclude that the employer is being unfair. As a result, they might withhold effort and lower their commitment to the employer.

Procedural justice deals with employees' perceptions of fairness of the process by which decisions are made and includes the extent to which employees can participate in the process as well as the rules followed.[28] For example, by establishing rules for eligibility and contributions to retirement plans, employers can ensure procedural justice perceptions. Additionally, allowing employees to have voice in the use of such benefits as self-development and education can also enhance their perceptions of procedural fairness.

Interpersonal justice is the perception of the degree to which the employer demonstrates concern and social sensitivity toward employees.[29] As an illustration, managers' awareness and concern for employee development and needs and encouraging employees to participate in the benefits program is likely to lead to fairness perceptions about interpersonal justice.

Informational justice deals with perceptions about the quality of information used to explain organizational decision making.[30] If an employer decided to offer certain benefits or change/withhold others, the accuracy and timeliness of information will influence their perceptions of informational justice. For example, a company eliminates transportation benefits (deeply discounted public transportation passes). If the company intentionally or unintentionally fails to inform and educate their employees about elimination of transportation benefits, employees may judge the employer's decision as unfair.

While earlier human resource practices were standardized, today there has been a shift toward nonstandardized, idiosyncratic work arrangements.[31] This is largely driven by the increased competition to attract and retain top talent on the part of companies[32] as well as increased expectations of employee involve- ment.[33] Employee benefits can be a part of this new individualized employment relationship.

In addition to perceptions of justice and fairness, employees can also form perceptions of organizational support based on their experiences. **Perceived organizational support** is an employee's perception of the degree to which the employer values the employee's contributions and well-being.[34] Organizational support may implicitly incentivize higher job performance, becoming a part of the social exchange relationship.

Certain employee benefits practices can act to signal organizational support. Employee benefits that signal the organization's concern for the well-being of the employee, such as mental health benefits, wellness programs, smoking cessation programs, and stress management, as well as those aimed at recognizing the employees' contributions such as recognitions and rewards, will help in fostering perceptions of perceived organizational support.

Emotionally committed employees have increased performance, reduced absenteeism, and decreased likelihood of turnover. Employers can ensure commitment by showing support to employees in the form of pay and promotion, approval and respect, and other aids needed to be effective in the company.[35] Certain rewards and job conditions are more likely to lead to perceived organization support, such as recognition, pay, promotions, job security, autonomy, and training.[36]

Those human resource practices that indicate investment in human capital and demonstrate recognition of employee contributions will certainly promote perceptions of organizational support.[37] For instance, educational assistance programs are an example of investment in human capital, and pay raises and promotions recognize employee contributions. Thus, these practices will lead to employees feeling supported by the company.

From a social exchange perspective, employees will value the employer's discretionary efforts more highly than those that are beyond the employer's control.[38] Thus, discretionary employee benefits, offered to employees at the employer's own choice, are more likely to generate perceptions of organizational support than legally required benefits. Additionally, those discretionary benefits that address most closely the employee's needs for well-being and development are more likely to elicit perceptions of organizational support. The importance of flexible benefits practices, suited to the diverse necessities of the changing workforce, can hence be understood in terms of critical employee attitudes such as perceptions of fairness and perceived organizational support.

Organizational Citizenship Behavior

Employees' discretionary behavior, not explicitly or directly recognized by the formal reward system of the employer, but in aggregate promoting organizational effectiveness, is termed as **organizational citizenship behavior.**[39] Thus, behaviors such as helping other employees, looking out for the employer's interests, going beyond job requirements to help achieve company goals, are all examples of organizational citizenship behavior. Satisfied employees engage in good citizenship behavior. A company's employee benefits practices can influence employees' satisfaction.

Organizational citizenship behavior is discretionary—it is not enforceable but rather a matter of personal choice. Citizenship behaviors tend to go beyond the formal job requirements. Such behaviors are not easily governed by individual incentive schemes because they are often difficult to discern and measure.[40] For instance, an employee who is helping a coworker to succeed without any motive of recognition or reward from the employer is exhibiting citizenship behavior. Organizational citizenship behavior is a deliberate attempt by the employee to maintain the balance in the social exchange between the employee and the employer and is directly intended to benefit the employer.[41] If employees perceive their employer as generous and fair, they will seek to reciprocate by showing good citizenship behavior (in addition to job performance and commitment).

Employees' perceptions of both distributive and procedural justice are likely to affect citizenship behavior. If employees perceive that the employer is unfair, they will withhold good citizenship behavior.[42] For instance, if an employer decides to stop offering flextime benefits to an employee, and the employee perceives this as unfair, the employee can decide to stop putting in extra hours of work that she was previously doing in order to finish a project faster. Employee-benefits practices that lead to perceptions of injustice or feelings of contract violations might also lead not only to poor performance, reduced commitment, and increased likelihood of turnover, but also reduction in extra-role, prosocial behaviors to help the employer be effective.

As stated earlier, job satisfaction can lead to organizational citizenship behavior that has effects on job performance.[43] There could be two reasons why job satisfaction would lead to organizational citizenship behaviors. It could be because people tend to reciprocate those who benefit them. Hence, if satisfaction comes largely from work, then employees may reciprocate with helping behaviors in the workplace. Also, employees who are satisfied and experience positive mood states tend to engage in good citizenship behaviors.

The concept of organizational citizenship behavior is based on social exchange. As such, employee benefits can be seen as eliciting job satisfaction and citizenship behaviors. In exchange for generous benefits and human resource practices, employees can use good citizenship behaviors to reciprocate and signal commitment and loyalty to the employer. Thus, employee benefits are an important part of the social exchange process that characterizes the employment relationship. They can be an important component of employees' psychological contract with the employer.

How companies design, communicate, and implement employee benefits can lead to varying perceptions of fairness and organizational support. As a result of these attitudes, employees will engage in related organizational outcomes such as job performance, commitment, and citizenship behavior. Thus, the role of employee benefits in eliciting organizational effectiveness is undeniably important.

THE ECONOMICS OF EMPLOYEE BENEFITS: WHY DO EMPLOYERS OFFER BENEFITS?

Most employers compensate employees with some combination of cash and benefits, such as health insurance. This combination of cash and benefits represents the extrinsic component of total compensation, as discussed in Chapter 1. At first glance, it might seem that employees and employers would both prefer a cash-only compensation package rather than a mixture of cash and benefits. After all, employees can use cash to buy life or disability insurance, save for retirement, or buy any other goods or services they want. This freedom would allow employees who want a generous life insurance plan to have it, while employees who prefer a cheaper life insurance plan could spend less on life insurance and have more money available for other goods and services. Additionally, benefits are expensive and time-consuming for employers to administer. Year-to-year changes in the costs of health insurance make benefits planning particularly difficult. It would seem, therefore, that employers also might prefer to pay all employees in cash only. So what advantages are there to employers and employees from having benefits?

Before answering this question, it is important to clarify that the question is not meant to ask whether an employer should pay, for example, a salary of $50,000 per year plus a tuition reimbursement plan and a retirement plan, or whether the company should pay $50,000 per year without the tuition reimbursement and retirement plans. Clearly, if an employer could recruit and retain the same workforce with both pay packages, it would prefer not to offer the costly benefits. Instead, the question is whether an employer would want to reduce the amount of cash compensation and substitute the tuition reimbursement and retirement plans. The relevant choice for the employer might be between paying $50,000 a year plus benefits versus paying $75,000 a year and providing no benefits; or, the choice might be between paying $50,000 a year plus a generous and expensive retirement plan versus paying $60,000 a year plus a less-generous and cheaper retirement plan.

An employer might choose to include benefits in its compensation package for three primary reasons:

- A cost advantage to the employer
- Recruitment of certain types of workers
- Tax incentives

Cost Advantage

The first reason an employer may want to provide a benefit is that the employer may be able to buy the product or service at a lower cost than employees would pay if they tried to buy it on their own. Health insurance is a perfect example: Employers can generally purchase health insurance for a substantially lower premium per enrollee than the amount employees would have to pay for identical coverage if they bought the insurance on their own. A particular insurance plan might cost $1,000 per employee when purchased by an employer that employs 500 workers, but the same insurance plan might cost $2,500 if purchased by a single individual. Employees are therefore better off getting the health plan through their employer and having their cash wages reduced by any amount less than $2,500. The employer is better off by providing the health insurance to its employees and reducing their wages by anything more than $1,000. Together, this means that both the employer and the employees will be better off if the compensation package includes the health plan and salaries are decreased by an amount between $1,000 and $2,500. When the employer can buy a benefit for a lower cost than the employee could buy it, the employer is essentially acting as a buying agent for the worker. 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.

Why does health insurance become less expensive when the size of the insurance group increases? Many products are sold with quantity discounts. Is health insurance just another example? Actually, it isn't that simple. Three primary reasons explain why insurance costs tend to fall as the insured group—also known as the insurance pool—gets larger. First, as the group gets larger, insurance becomes less risky to provide. Second, insurance companies need to worry less about the phenomenon of high-risk individuals driving out low-risk individuals in large insurance groups in which all members are required to buy insurance. Third, as the group gets larger, fixed administrative costs can be spread out among more people. These factors will be discussed in turn.

As the size of the insured group gets larger, it becomes much easier for the insurance company to predict the total medical expenses for the group. That means it is less risky to provide health insurance to a larger group than to a smaller group. For example, in 2013, average total medical expenditures were $4,855 per person and by age:

- $1,980 for children aged 5 to 17
- $3,665 for adults aged 18 to 44
- $6,737 for adults aged 45 to 64
- $10,125 for adults aged 65 and older

Medical expenses also tend to be higher for women than for men, and higher for whites than for minority groups.[44] Medical expenses are also naturally higher for people who have experienced medical problems in the past. Insurance companies can use these and other data, in combination with information on the characteristics of the group to be insured, to come up with an estimate of the expected medical expenses that the group will generate over the upcoming year. In very large groups, total medical expenses are likely to be close to those predicted by the age, gender, and past medical history of the group. The number of people who have particularly bad luck and have larger-than-expected medical expenses is likely to be offset by a roughly equal number of people who have smaller-than-expected medical expenses. In a small group, by contrast, there is much less certainty that the number of people with bad luck will roughly offset the number of people with good luck. That is, it is much more difficult to predict the medical expenses a small group will experience in the future.

A different way to think about this is to note that if you flipped a coin four times, you would expect to get two heads and two tails, but you would not be terribly surprised if you got three heads and one tail. By contrast, if you had the energy to flip the coin 1,000 times, you should be very suspicious about the authenticity of the coin if you ended up with 750 heads and 250 tails. The more times you flip a coin, the more likely it is that you'll receive roughly the same number of heads as tails. In the case of health insurance, the more people in the group, the more likely that total medical expenses will be close to those predicted by the characteristics of people in the group.

The fact that total medical expenses—and hence the amount that insurance companies have to pay out to medical care providers—are more predictable for larger groups of people means that insurance companies bear less risk when they insure these larger groups. They are therefore willing to provide the insurance at a lower cost to larger groups than to smaller groups. Smaller groups, by contrast, tend to face higher insurance costs to compensate insurance companies for the added risk they bear. Similarly, an insurance policy that covers a single individual or family will tend to be more expensive than a similar policy that covers a small group of people. Because of the riskier nature of individual and small group policies, they are more likely to be subject to what is called **medical underwriting,** a process by which employees provide information on their past medical history in a questionnaire or physical examination. Insurers use this health information to exclude coverage or to tie premiums more closely to past medical history.

The bottom line is that employers can purchase group health insurance at a better rate than individuals could purchase the same policies on their own. This gives employers and employees an incentive to have a compensation package that includes group health insurance in lieu of some cash wages or salary. It also means that this incentive is relatively larger for big employers than for small employers, which explains in part why small employers are less likely to offer health insurance to employees.

A second motivation for employer-provided insurance is to avoid an inherent problem in insurance markets that is referred to as **adverse selection.** This is the tendency of an insurance pool to disproportionately attract "bad risks" and discourage the participation of "good risks." Suppose a health insurance company operating in a particular city does market research and concludes that the average resident has medical expenses of $5,000 per year. On this basis, the insurance company offers residents a comprehensive health insurance policy with a premium of $5,500 per year. Which residents would choose to buy this plan?

Clearly, people who think that they are relatively healthy and therefore unlikely to have anywhere close to $5,000 in expenses are not going to buy this health insurance plan. On the other hand, people who think that they are more likely to have high expenses are likely to buy the plan. Thus, the average medical expenses of people who buy the plan will be greater than $5,000, since only people with relatively high medical expenses will purchase the plan. The insurance company has a risk pool composed mostly of "bad risks." The result is that the insurance company can no longer afford to offer this plan for $5,500 and will have to raise its premium. This will lead the insurance pool to become even more unbalanced as some of the healthier policyholders decide that the policy is too expensive given their own expected medical costs.

Adverse selection in insurance markets stems from the fact that individuals know more about their own health status than does the insurance company. One solution to this problem is for the company to gather as much information as possible about each participant's risk profile and then offer the insurance at a lower price to healthier people and at a higher price to less-healthy people. This is referred to as **experience rating** and is how most automobile insurance policies work. It is also how most individual, single-family, and small-group health insurance policies work.

A different solution to the adverse selection problem is for a large group of people who come together for some other purpose to buy group insurance together, with the requirement that all group members must buy into the insurance pool. A group of people who come together to build and sell television sets, provide investment advice, or teach college students, for example, are unlikely to be composed of disproportionately good or bad risks. In any event, as long as everyone in the group is required to participate in the insurance pool, the insurance company can set the premium accordingly without fear that relatively good risks will drop out.

Avoiding the adverse selection problem is one reason why employment-based insurance is so popular, especially among large and medium-sized employers.

It also helps to explain why employers provide a whole range of insurance products as part of a benefits package, including disability insurance and life insurance. Indeed, avoiding the adverse selection problem is one justification for various government-provided insurance programs, such as Social Security, Medicare, and workers' compensation programs.

Finally, administering an insurance policy involves a good deal of paperwork, claims processing, and other administrative functions. Many of these functions are not much more time-consuming and expensive to perform for a large group than for a smaller group, a process referred to as **economies of scale.** Because of this, as the group gets larger, the fixed costs of these administrative tasks can be shared among a larger number of people, thereby reducing the average cost per insured person.

Recruiting Certain Types of Workers

A second reason that employers may want to offer a compensation package that includes both cash and benefits is to aid in recruiting and retaining certain types of employees, particularly when the employer's managers have a difficult time observing all relevant characteristics of potential employees. In management's perfect world, job applications would contain all relevant information about a potential worker, such as his or her future productivity, work habits, career plans, commitment to the employer, and commitment to undergoing future training. Unfortunately, many important characteristics are not observed, and managers may have a difficult time eliciting such information. By offering a compensation plan that includes both cash and benefits that are more highly valued by some applicants than by others, an employer may be able to get applicants to reveal some of these characteristics themselves.

For example, suppose the ideal candidate for a particular employer is a highly motivated recent college graduate who would like to work for a few years and then go to graduate school to earn an MBA. Looking at the job applications received by the employer, however, it is difficult to tell which potential employees actually fit this description. How should the employer go about selecting a candidate?

One strategy is that the employer could simply ask each applicant whether he or she is highly motivated and would like to earn an MBA. However, talk is cheap, which makes this strategy problematic. All of the applicants would likely say that they fit this description if they think it will increase their chances of getting the job. Also, potential employees may not know for sure whether they will want to go on to earn an MBA or may not know what the employer defines as being “highly motivated.” The employer needs a way to separate those applicants who are truly motivated and interested in getting the advanced degree from those who are not.

A second strategy is that the employer could offer a pay package that includes a slightly reduced salary and also the promise to pay tuition in an MBA program. (In Chapter 9, **tuition reimbursement benefits,** which fully or partially reimburse an employee for expenses incurred for education or training, will be discussed.) This package would be valued relatively more by the exact employees whom the employer wants to recruit. Potential employees who feel that there is little chance they would seek an MBA would prefer to take a job with a higher salary without the promise of tuition assistance. Offering the tuition assistance in the compensation package would induce highly motivated potential employees to reveal valuable information about themselves to the employer.

Offering particular benefits in a compensation package could also have unintended consequences for the types of employees most attracted to the employer. For example, an employer that touts its generous benefits for mental health services or substance abuse treatments may feel that it is offering a progressive benefit package. However, it may also find that the types of employees who are most likely to accept a position with the employer, or who are most likely to stay with the employer, are those suffering from conditions that require such services or treatments. In some cases, this may not be the outcome that the employer intended.

Tax I ncentives

A third reason that employers may want to offer benefits is that the U.S. federal tax code—the Internal Revenue Code (IRC)-provides financial incentives to do so. The most important tax provision is that many benefits are not taxed as income to employees. Suppose an employee has a 25 percent marginal tax rate. If the employer increases her pay by $1,000 in cash, she must pay $250 of that to the government, leaving her with $750 in after-tax income. By contrast, if the employer gives her a benefit that costs $1,000, she receives the full benefit and does not incur any tax burden. A different way to see the effect of taxes on benefits provisions is to suppose an employee wants to buy a life insurance policy that costs $1,000. If she were to buy the policy on her own, she would have to earn $1,333.33. Of this, she would pay 25 percent, or $333.33, in taxes to the government, which would leave her with $1,000 in after-tax income needed to purchase the insurance. She would be better off receiving the plan as part of her compensation package and having her salary reduced by any amount less than $1,333.33. If her employer could buy the same policy for $1,000, the employer would also be better off by including the insurance in the compensation package and reducing the employee's wage by any amount over $1,000. Within these stated limits, the employer and employee are both better off if the insurance plan is part of the compensation package and the salary is reduced by any amount between $1,000 and $1,333.33. Retirement plans are a second example of a benefit that is partly driven by generous tax treatment. More details about tax treatment of benefits are provided in Chapter 3 and in other chapters, as relevant.

All three of the preceding motivations presuppose that employees value a particular benefit and are willing to give up something to receive it. There are two important consequences of this. First, employers need to figure out the cash value that employees place on a particular benefit and which types of employees value the benefit more than others. Second, if employees are willing to give up something to receive a particular benefit, then the cash component of wages and the types and amounts of benefits an employer offers will be inexorably linked. This link is the subject of the next part of this chapter.

Students usually give two other answers when asked why they think employers offer benefits. The first answer is that employers are just trying to match what every other employer is doing. This probably has a lot of truth to it: A lot of businesses do a lot of things simply because everyone else is doing it. Managers may not have the time, inclination, or expertise to investigate every alternative business practice, so why not cut some corners and follow the pack on compensation practices? This argument, though, doesn't really answer the question—it just leads us to ask, Why does every other employer offer benefits? If all employers continued to follow unprofitable compensation practices, then presumably, new employers would enter the market to take advantage of unrealized profit opportunities. Existing employers would either follow the lead of new, more-profitable employers or eventually find themselves out of business.

The second answer is that employer managers want their employees to be well, so they provide wellness plans, or they want their employees to be well prepared for retirement, so they offer retirement plans. It is clear that most employers' managers do, in fact, want their employees to be well, but it is not obvious that this is why employers offer wellness benefits. First, is directly providing wellness benefits or a retirement plan the most effective way for an employer to promote these goals? Second, why would employers choose to promote these goals in their compensation policies rather than promote other worthy goals?

WHO PAYS FOR BENEFITS?

One of the biggest misconceptions about employee benefits is that employers give them as "free add-ons" in compensation packages and that employees do not give up anything to receive these benefits. The truth is that, in large part, employees pay for all of their benefits in the form of lower cash wages or salaries than they would have otherwise received. An important consequence of this is that when the cost of providing a benefit increases, it is employees who pay for the increase; employers' profits are generally not affected.[45]

The degree to which an increase in benefits costs is passed along to employees in the form of lower cash wages generally depends on four factors:

- The cash value employees place on the benefit.
- The degree to which employers will increase or decrease their hiring when the market compensation level decreases or increases, and the degree to which employees will change their desire to work when the market compensation package changes.
- Whether the benefits cost increases for all employers in a market or only for a particular employer.
- Whether the hiring decisions of a particular employer affect the market compensation level.

Let's begin by more precisely defining the concept of the "value that employees place on the benefit." Suppose you've just accepted a new job and your employer offers you the choice of a $75,000 annual salary plus a comprehensive educational assistance plan, or a $90,000 salary and no educational assistance. Which compensation package would you choose? Both options probably would have some takers. Those who want to earn a graduate-level degree will tend to place a relatively higher value on the educational assistance benefits, and they are therefore more likely to forgo the extra $15,000 in salary. On the other hand, people with graduate degrees are more likely to choose the extra salary in lieu of the educational assistance benefits.

Some people may be uncomfortable with the concept of placing a dollar value on educational assistance benefits or on any product. Although we aren't always conscious of it, every time we buy a product or service, we are implicitly deciding that we value the product more than (or equal to) what the merchant is charging for it. Workers make choices about which job to accept, how many days or hours to work each week, and even whether to work at all, based in part on a comparison of the value of compensation packages and the value they place on their leisure time or time spent doing unpaid work at home.

The first lesson is that the greater the value employees place on a benefit, the larger the reduction in cash wages that they will accept if the benefit is introduced into a compensation package. Suppose an employer currently offers a compensation package that only includes a cash salary of $100,000 per year, but she is thinking about introducing new benefits that cost her $10,000 per year. If she simply added the benefits to the $100,000 salary, her total profits would decrease by $10,000 times the number of employees. For the employer to consider offering the new benefits and also maintain her profit level, she would have to reduce the salary she offers by at least $10,000.

Would the employer be able to recruit and retain the same workforce if she reduced the salary from $100,000 to $90,000 per year? This depends on the value that potential employees place on having additional benefits. An employee who values the plan at exactly $10,000 would be indifferent to a change from the current compensation package of $100,000 plus no new benefits to a new package that includes a salary of $90,000 plus the new benefits. In general, though, there are bound to be some employees who value the plan at less than $10,000 per year and some who value it at more. Any employee who values the plan at less than $10,000 per year would view this move as a cut in compensation and would likely seek employment elsewhere.

By contrast, employees who value the new benefits at more than $20,000 per year would view this as an increase in compensation. The employer could cut the salary from $100,000 to $85,000 per year and these employees would still be better off (because they gave up $15,000 per year in salary and received additional benefits they valued at $20,000 per year). What's more, the employer's profits would rise, because labor costs would go down by $5,000 per employee per year. In effect, the employer would be buying additional benefits and providing these benefits to employees at a lower cost than the amount that employees value the benefit.

Let's think through what would happen if the employer introduced the $10,000 benefits but kept cash wages at their initial level of $100,000 per year. At the same time, other employers would either continue to pay a salary of $100,000 per year with no additional benefits or would offer a lower salary and include the additional benefits. One consequence is that profits would fall by $10,000 times the number of employees. The employer may try to raise the price that she charges her customers, but competition from other employers with lower labor costs would certainly make it difficult to sustain this strategy. Thus, faced with reduced profits, the likelihood that this employer will go out of business is increased. In extreme situations, such as in the commercial airline industry, employees will be willing to accept significant cuts in pay and benefits to help the company remain in business.

If the employer remains in business, workers at other companies and people out of the labor force would realize that the employer was offering a significantly more-generous compensation package than those offered by other employers. The employer's human resource manager would soon realize there are many more applications than there are positions. The employer would find herself in a position in which she can be choosier about which employees to hire and also find that she can fill her staffing needs at a lower salary. Thus, it's unlikely that the employer would continue to offer an above-market compensation package.

What would happen if the employer decided to cut wages by more than the amount that employees value the additional benefits package? Let's assume that the employer cut salaries from $100,000 per year to $80,000 per year, but employees only value the new benefits at $10,000 per year. In this case, employees would view their total compensation package as being worth $90,000, or $10,000 less than what it was previously. Some employees would decide that they would prefer to work for another employer, or not work at all, rather than take a pay cut. To fill her staffing needs, the employer would have to raise her cash wage to maintain the value of the total compensation package.

A related but more common scenario is that an employer already offers a compensation package that includes both salary and benefits, and the cost of providing some benefit increases. The leading example is the steady rise in health insurance costs experienced by most U.S. employers. Suppose you are a human resource manager and your CEO tells you that your health insurance company is going to raise the rate it charges your employer for health insurance by 10 percent for the coming year. Since this rise stands to cost the company a lot of money, one option that the CEO proposes is to scale back a planned salary increase for the coming year from 5 percent to 3 percent. This 2 percent savings will offset the 10 percent increase in health insurance costs. What is your reaction to this proposal?

Do you think a decline in the growth of wages will lead some employees to leave the employer? What factors are important in answering the question?

One thing to consider in this situation is the underlying reason for the rise in health insurance costs. The following are some examples: [1]

1. The rise reflects a general improvement in medical 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 percent only for 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 percent only for this employer because the employer decided to lay off a significant portion of employees, thereby reducing the size of the insured group.

These scenarios are distinguished by whether the rise in medical costs reflects something that adds to employees' valuation of the insurance (Examples 1 and 3) or does not add value (Examples 2 and 4), and by whether health insurance costs rise for all employers (Examples 1 and 2) or for just this particular employer (Examples 3 and 4). Take some time to think about whether your reaction to the CEO's proposal depends on which of the four preceding explanations is the cause of the increased health insurance rate.

The conclusion reached earlier that employees' cash wages will tend to fall whenever benefits are fully valued also holds when benefit costs rise. That is, wages will tend to fall when health insurance cost increases derive from improved quality of care (Example 1) or an increased use of care among employees (Example 3). From this viewpoint, gloomy assessments of the recent increases in health-care costs may have missed the point entirely. If rising health insurance premiums signal that health care is more valuable, then recent rises in health-care costs are good news for employees—at least for those who use medical care.

On the other hand, if increased health insurance costs are not accompanied by an increase in employees' valuation of the insurance, as in Examples 2 and 4 above, cash wages may not be able to adjust downward. Whether or not cash wages will, in fact, fall depends on two additional factors: (1) whether health insurance costs rise for this particular employer only or for all employers in the market, and (2) the degree to which workers and employers will change their labor demand and supply when compensation costs change.

When health benefits costs rise for a single employer in a market, the employer will likely not be able to pass along the benefits costs to workers if the workers' valuation hasn't changed (or has increased, but by less than the increased benefit cost). Let's work through an example. Suppose that to hire an average-quality lawyer with 10 years of litigation experience, a law firm in New York City must offer a total compensation package worth about $100,000. An offer of less than that will likely only attract the lowest-quality lawyers, if any at all. Let's suppose the firm of Lawyers Inc. currently meets the market by offering a compensation package of $80,000 in salary and a health insurance package valued at $20,000 by the current employees. Now suppose that the employer lays off a quarter of its staff, thereby reducing the size of the insurance pool. Thus, the same policy now costs the employer an extra $5,000 per employee per year. Could the law firm reduce the salary level from $80,000 to $75,000?

Probably not. The increase in health insurance costs were not accompanied by any increase in employees' valuation of the insurance, so employees still value their insurance at $20,000 per year. If the market compensation level remains at $100,000, the law firm must maintain the $80,000 salary in conjunction with the insurance to meet the market and retain its current workforce.

The salient factors in the last scenario are that the employer must meet the market compensation level and that health insurance costs rose only at this law firm. Thus, the employer must pay the increase in costs.[46] Many commentators and business leaders mistakenly apply that conclusion to the more general scenario of when health insurance costs rise for all employers. The same logic does not carry over, however. To investigate the response of wages to an economy-wide increase in benefit costs, let's pick up with Example 2 above, in which health insurance costs rise because doctors' fees increase. Clearly, the employees' valuation of their health insurance plan has not changed. There is a still a possibility for wages to offset the health insurance cost increase, however. The degree to which wages will fall—that is, the degree to which employees pay for the cost increase—depends on the degree to which workers will drop out of the labor market when their compensation level falls and on the degree to which employers will reduce their workforce when employment costs rise. To understand this, let's consider two relatively polar opposite cases.

In the first case, employers are relatively insensitive to changes in compensation costs, but workers are sensitive. That is, employers would go about hiring approximately the same number of people if compensation costs rose or fell by 10 percent. By contrast, if total compensation fell by 10 percent, many workers would decide that they have better uses for their time (such as raising children at home, staying in school a little longer, or retiring a little earlier) and choose not to work anymore. If total compensation rose by 10 percent, some people who are not working might choose to do so.

In this situation, employers that would not generally be able to pass along higher benefits costs to their employees instead will end up paying for the benefits out of their profits. What would happen if an employer did try to pass along the benefits costs to employees? Since employees' valuation of their benefits did not change, the decrease in salary would certainly be viewed as a decrease in total compensation. Thus, some employees would likely begin looking for employment elsewhere. Workers in general would gravitate toward employers that maintained their salary base in the face of higher benefits costs. However, we've assumed in this scenario that employers' hiring needs are relatively insensitive to compensation costs. That is, employers still need about as many workers now as they did prior to the benefits cost increase. Thus, employers that cut wages and lost employees would need to hire additional workers to replace them, which would necessitate raising their compensation level—the result being that the employer would pay the increase in benefits costs.

What if all employers could somehow agree to pass along the higher benefits cost to employees, perhaps through contributory financing or employee-financed methods, so that workers didn't have the option of moving to higher-wage employers? Workers in this scenario have the option of leaving the workforce altogether. Thus, if all employers decided to cut wages, some workers would leave the labor market, leaving some employers understaffed. The smaller workforce would force employers to raise their wage offers to fill their staffing needs. The bottom line is that if workers are willing to leave the labor market when compensation falls and employers have relatively inflexible staffing needs, employers will tend to pay for some or all of the benefits cost increases. (In practice, more companies would lower their costs for providing health-care benefits by selecting options with higher deductibles or copayments [Chapter 5] instead of reducing wages or salaries.)

In the second scenario, employees are totally insensitive to market-wide changes in compensation levels. That is, if total compensation fell by 10 percent with all employers, no workers would reduce their hours or weeks of work or drop out of the labor market in response. This is what is meant by "insensitive." Although this view of workers' behavior may sound rather extreme, there's actually quite a bit of evidence that most prime-age workers (those aged 30 to 54) behave this way, especially men. By contrast, the groups most likely to adjust their labor supply—and thus fit the previous scenario—are women with young children, the elderly, part-time workers, and young workers.

In the situation in which employees are totally insensitive to changes in market-wide compensation levels, all the increase in benefits costs will be passed along to employees in the form of lower salary levels, even if employees' valuation of the benefit has not changed. An employee whose salary was reduced by the cost of the benefit might at first perceive a cut in his pay relative to what he could receive at other employers, and thus he would try to seek employment elsewhere. However, all employers have experienced the same increase in benefits costs, and thus all employers will be seeking to cut salaries. Thus, the employee would soon find that, although his salary has been cut, so have the wages at other employers. The employee's only options are to drop out of the labor market altogether or accept the lower pay, and we've ruled out the former. Exhibit 2.4 summarizes whether employers or employees will tend to pay for a benefits cost increase in various scenarios.

EXHIBIT 2.4
Summary of the Incidence of Employee Benefits Cost Increases

Does employees' valuation of the benefits increase?	**Employees' valuation increases at least as much as the benefits cost Employees' valuation of benefits increases. does not increase.**	
Do costs increase for all employers in the market?	**Costs increase for single employer.**	**Costs increase for all employers.**
Who pays for benefits cost increases?	Employees pay Employer pays for all benefits for all benefits cost increases. cost increases.	Employers and employees split the cost increase. The party that is least likely to adjust tends to pay more.

Most workers with employer-sponsored health insurance pay a token monthly contribution toward their health insurance premium, which is typically deducted from each monthly paycheck. According to data from the 2015 National Compensation Survey, most employees were required to make a contribution to their health insurance costs. The typical monthly contribution ranged between approximately $28 and $300 for single coverage and between $86 and $1,279 for family coverage.[47] The monthly premium is usually paid from pretax dollars and usually represents only a small fraction of the actual cost of the health insurance. Importantly, this monthly payment should not be interpreted as employees' only contribution to their health insurance. Rather, the view advanced in this chapter is that the full cost of health insurance is paid for by employees. Part is paid for through this monthly contribution, and the remainder is paid for through lower cash wages.

It may seem peculiar that employers charge employees these monthly contributions since they come from after-tax dollars. One advantage of these fees, however, is that they easily allow employers to charge different health insurance prices to people with different family sizes, or to people who choose health plans of different quality. A second advantage is that employers can more easily raise these contributions when benefits costs increase, making it more evident to the workers that health costs have increased.

Business managers and human resource practitioners sometimes question whether economists' view of the relationship between cash wages and benefits is correct, because, they contend, employers are rarely observed cutting wages when a new benefit is introduced or the cost of providing an existing benefit increases. In fact, such wage cuts happen much more frequently than some might think. An employer may scale back a scheduled bonus or reduce the year-to-year rate of growth of cash wages. An employer may also hire new workers at a lower wage rate than that which existing workers are paid. If there is relatively fast turnover, the wage decrease will quickly filter through the employer. Finally, an employer may increase employees' "contribution" to their health insurance premiums. An increase in the contribution is in effect taking compensation out of the hands of employees, which has the same effect as a reduction in cash wages. A difference is that increasing the benefits contribution helps employees realize that their wage cut results from an increase in their benefits costs, not from, for example, a decrease in the employer's profitability. For an employer with both employees who receive health insurance and employees who don't, increasing the contribution may be a particularly effective way to target a wage decrease on those employees whose benefits costs were actually affected.

Summary

This chapter discusses the psychological basis of employee-benefits practices from the point of view of employees, as well as the economics of employee benefits from the perspective of employers. Taken together, these topics illuminate the importance of offering employee benefits. Psychologically, employee-benefits practices can fulfill employees' transactional and relational expectations of the employer and the employment exchange relationship. If employees view their employer's benefits program as fair and meeting their expectations, then those employees will be satisfied and productive. When employees are satisfied and happy with the way the employer is treating them, they will be committed to the employer and even engage in good citizenship behaviors. Hence, it is important for employers to understand employee perceptions and attitudes about employee benefits. This will allow employers to design and communicate benefits programs that can attract and retain productive and committed employees. The economics of employee benefits explore why employers offer a mixture of cash and benefits and whether workers tend to pay for benefits cost increases in the form of lower cash wages. The primary reasons why employers offer benefits are that they can purchase the benefits at a lower cost than could employees on their own, employers use benefits to attract particular types of employees, and the government gives employers a tax incentive to provide some benefits. Whether workers or employers pay for benefits cost increases depends crucially on why costs increase, whether costs increase for all employers in the market, and how willing employees and employers are able to adjust their labor supply and demand when compensation costs change.

Key Terms

social exchange, *32*
economic exchange, *33*
psychological contracts, *35*
transactional psychological contracts, *35*
relational psychological contracts, *35*
distributive justice, *39*
procedural justice, *39*
informational justice, *39*
interpersonal justice, *39*
organizational support, *41*
organizational citizenship behavior, *39*
medical underwriting, *44*
adverse selection, *45*
experience rating, *45*
economies of scale, *46*
tuition reimbursement benefits, *46*

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?
2. What are psychological contracts? Discuss the main features of psychological contracts and how they develop. Discuss how employees' psychological contracts might be violated and the consequences of these violations for employers.
3. How do perceptions of employee-benefits plans influence organizational justice and organizational citizenship behavior?
4. 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. Even if a particular benefit is cheaper for an employer to provide, would that employer always want to provide it? Why or why not?
5. 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?

Cases

1. Understanding Your Employee Benefits: Forgoing a Benefits Package

As you consider how to move ahead in your career, it seems like a good time to explore other job opportunities. You generally like your current job but feel that your future opportunities are limited within your company. You are fortunate that your skill set is in demand and you have already received a couple of offers, but you are surprised by the variation of the compensation in the offers. You know that, as you consider an offer, you should consider both the salary and the value of the benefits. As you compare the offers, you start to consider what you really value in compensation.