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Employee Compensation: Know the true costs of employment and optimize them to benefit employers, employees

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THE TOPIC: WHEN IT COMES TO EMPLOYEE COMPENSATION, WHAT THEY DON'T KNOW COULD HURT YOU

Employers want to present themselves in the best light to current and prospective employees to gain a competitive edge. However, one commonly overlooked point of differentiation is the total compensation package that an employer offers—not just take-home salary, but the benefits and other job attributes that can constitute a significant portion of employees' overall compensation.

In the past, many firms offered comparable benefit packages, and companies generally did not need to specifically point out the value of their benefit programs. Indeed, employees often took generous benefit packages as a "given." However, employers should ensure that prospects and current employees are fully aware of the total compensation they are offered.

KEY FINDINGS

- While most employees—and possibly some employers—think of employee compensation primarily in terms of "wages" or "salary," many employees' total compensation packages add up to a significantly larger figure.
- Many employees don't understand the actual costs of their total compensation packages.
- Many employers do not adequately communicate to employees the cost of benefits they provide.
- Different employees place different values on specific benefits.
- Offering choice over the mix of compensation has some costs, but can benefit both firms and employees.

In addition, employers may be well served to consider redesigning their benefit packages to make sure they are receiving the most for their money. Specific employee populations may value certain benefits more than others, based on such characteristics as their marital and family status, age, gender, or investment knowledge, for example. Thus, employers may gain a significant competitive advantage by offering choice to individuals regarding the benefits they receive. In a paper (and forthcoming book)[1], Cornell ILR School professor Kevin Hallock explores the real cost of employment and how this may differ from how employees value their compensation packages.

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THE STUDY QUESTIONS

Among the questions the research explored are:

- **Are employees aware of the full costs of their compensation—especially benefits?**
- **What is the difference between the costs of compensation to employers and its value to employees?**
- **Does the actual cost of benefits for employers accurately reflect the value employees place on those benefits?**
- **Do employers understand the values that specific employees place on different forms of compensation?**

SOME FINDINGS

Take-home pay is only a fraction of the total cost of employee compensation. In fact, while employers spend on average $29.40 per hour for each employee (Employer Costs for Employee Compensation (ECEC), September 2009)[2], only $20.50 of that is in actual wages and salaries.

The actual costs of benefits may not accurately reflect their value to the employee. Employers would be well advised to think carefully about how to maximize benefits for specific employee populations and perhaps even specific employees.

Even employers are not always fully cognizant of the advantages they can realize by altering the mix of wages and benefits for different employee populations.

Compensation means much more than wages

The U.S. Bureau of Labor Statistics' ECEC survey measures the average cost to employers for wages and salaries and benefits, per employee hour worked. Of the $29.40 average hourly cost per employee in September 2009, $8.90—slightly more than 30 percent of the total—went toward various benefits. Put another way, employers' average expenditures for benefits were higher than the hourly wages earned by more than 10 percent of the U.S. population (U.S. minimum wage as of July 24, 2009, was $7.25 per hour).

Of the $8.90 (30 percent) figure, average expenditures for benefits break down as follows:

Compensation Component	% of Total Benefit Costs per Employee
Paid leave	**6.9%**
Vacation	3.4%
Holiday	2.2%
Sick	1.1%
Personal	0.3%
Supplemental pay	**2.6%**
Overtime or premium pay	0.9%
Shift differentials	0.2%
Non-production bonuses	1.5%
Insurance	**8.6%**
Health	8.1%
Life	0.2%
Short-term disability	0.2%
Long-term disability	0.1%
Retirement benefits	**4.4%**
Defined-benefit pension contributions	2.7%
Defined-contribution pension plans	1.7%

Employers must also pay for a required set of benefits, which accounts for 7.8% of the average total employee benefit costs per employee hour:

Legally required benefits	**7.8%**
Social Security	4.5%
Medicare	1.1%
Unemployment insurance	0.1%
Workers' compensation	1.5%

Gauging appropriate benefits for different needs

Hallock suggests that the actual costs of insurance, retirement benefits, stock options, and time off may not reflect the value that employees place on these forms of compensation. And workers in different personal situations will value benefits differently. For instance, a childcare benefit means little to a childless employee, and generous healthcare coverage for dependents is not particularly helpful to an unmarried employee. However, both of those benefits could be extremely valuable to someone with a family. In similar fashion, retirement benefits may have different value to a young worker than to an older employee.

Hallock suggests employers can optimize the salary/benefits formula by thinking carefully about how much benefits are worth to specific workers, versus how much they actually cost. He cites the real example of a worker who did not need her employer-sponsored health insurance because her spouse held a secure government job providing generous dependent coverage. The worker asked her employer if she could drop the health insurance, which cost the employer $10,000 annually, in exchange for $5,000 in additional salary. While this change would have benefited both employer and employee by $5,000 annually, the employer declined the worker's offer.

Hallock mentions that if employees are simply asked how they value specific benefits, they may not be able to give meaningful answers. Indeed, people are rarely able to predict their own responses to hypothetical situations. He suggests, rather, that changing compensation systems and observing employees' subsequent behavior provides concrete results for better decision making and company HR decisions.

For example, in one study, a company wanted to determine how specific employees valued stock options, possibly to gauge how much cash would be needed to replace the options if they were discontinued (Hallock & Olson, 2010)[4]. The estimates that the researchers formulated differed widely from those that some standard economic models would have predicted.

In a similar study, a firm told its employees that they could take either fewer stock options or less at-risk bonus in exchange for higher guaranteed salaries (Hallock & Olson, 2009)[3]. The researchers found that men preferred the more risky types of compensation (such as stock options and at-risk bonus) than did their female counterparts.

THE TAKEAWAY

How can the findings from this paper help HR practitioners think more critically about their employee benefit costs and options?

- **There is a huge disparity between the actual cost of an employee to an employer, and the take-home pay that the employee receives.**
- **Firms should consider more carefully communicating to employees their total compensation—not just their wages and salaries.**
- **When firms provide certain sophisticated forms of compensation, such as stock options, they should consider educating employees about the compensation.**
- **In the end, it is always good for firms to reconsider compensation strategy and communication. If employees don't understand pay, the pay isn't doing everything it could.**

THE ECEC SURVEY

Employers Costs of Employee Compensation (ECEC). Bureau of Labor Statistics, United States Department of Labor. September 2009. http://www.bls.gov/news.release/archives/ecec_12092009.htm

The ECEC survey covered roughly 62,700 occupations from a sample of 13,200 establishments in private industry and roughly 11,700 occupations from a sample of about 1,900 establishments in local and state governments. These data were obtained from employers, not employees. For more information about this survey, visit: http://www.bls.gov/news.release/ecec.tn.htm.

THE RESEARCHER

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4. Hallock, K. F., and Olson, C. A. (2010). New Data for Answering Old Questions About Employee Stock Options. In Abraham, K. G., Spletzer, J. R., and Harper, M. (eds.), Labor and the New Economy. National Bureau of Economic Research and University of Chicago Press.

For an in-depth discussion of this topic, see:

Hallock, Kevin F. (2010). Wages and Salaries Versus Total Compensation: Is there a Difference between Employee Value of Compensation and the Cost to Companies? In Pay, Chapter 4. Unpublished manuscript.

⋄ Questions about this paper should be directed to Kevin Hallock at hallock@cornell.edu.