Chapter 13 -- Benefits

Economics 136

Skip the appendix and pages 369-370 on paid time off

Main Questions

- 1) Why not offer just wages instead of wages and benefits?
- 2) What is a cafeteria plan, and why might a firm offer it?
- 3) What are the key aspects of pensions?
- 4) How can features of pensions affect turnover?

1) Why not offer just wages instead of wages and benefits?

- Firms often offer health/dental insurance, pensions, worker discounts, paid days off
- WHY?
- Overall, two broad explanations:

Firms May be Able to Provide Benefits More Cheaply Than Workers Can Buy Them

- If a worker values health insurance, but firm can provide it for $1000 less per year than if the worker buys directly, the firm can pay lower wages than otherwise
  - Can increase profits!!
- 1) Health insurance is cheaper if firm buys for all its workers than if they buy it individually because….

Other Reasons for Cost Advantages

- 2) Firms can buy a number of benefits more cheaply because have more bargaining power than individuals.
- 3) Firms can provide its own products at or near marginal cost to workers, making them feel better off
  - Example: Restaurants can feed employees cheaply during non-rush hours when excess capacity

Other Reasons for Cost Advantages

- 4) Tax advantages for firm to provide. Key example: In US firms can deduct health insurance costs from their taxable income but to employee this service is not taxable income.

Providing Benefits Can Generate Value for the Firm

- 1) Can improve sorting by providing benefits likely to attract certain workers
  - Example: Onsite daycare could be of value if firms seek younger workers because they find them to be more productive.
  - Or if crucial to keep highly able workers, offering subsidies for education could help (although dangerous as is general human capital!)

But Firms Can Hurt Reputation by Manipulating Benefits

- Walmart memo on how to attract younger healthier workers made national news, and plans were dropped
  - Requiring workers to move in all jobs
  - Increasing share of part time workers, who do not receive benefits, and who are generally younger

Providing Benefits Can Provide Value to the Firm (II)

- 2) Benefits can increase worker productivity
  - For jobs with long hours, provide workplace amenities to keep people at work longer (concierge services, car service, showers, kitchen)

Do Lavish Benefits for Top Executives Make Sense?

- Yermack (2006) finds that on day firms announce they have bought a personal jet for the CEO, stock price drops by 1.1% on average
  - Implies market thinks that such programs wasteful.

2) What is a cafeteria plan, and why might a firm offer it?

- Hard to know what benefits a specific worker may want most, and likely to vary across workers
- Cafeteria plans offer workers a given budget and then can spend it on various benefits, each with a separate cost
  - For example different types of health insurance, daycare, long term disability insurance
  - A problem is adverse selection – healthier workers do not choose health insurance!

3) What are the key aspects of pensions?

- Two main types:
  - Defined contribution
    - Firm contributes to worker's retirement account but does not promise it will deliver a specific income
  - Defined benefit
    - Firm contributes to central pool of money and guarantees payments to workers when retired
    - NOTE: The former puts more risk on the worker but latter plan is also risky to worker – what if firm goes bankrupt?!

Two Main Types of Defined Benefit Plans

- Pattern plan
  - Benefit = $B * Years of Service
    - Common in blue collar jobs and unionized occupations
- Conventional or Formula Plan
  - Benefit = G * (Years of Service) * (Average of Highest Compensation Earned)
    - Example: At UCSD, for a 65 year old, monthly retirement income

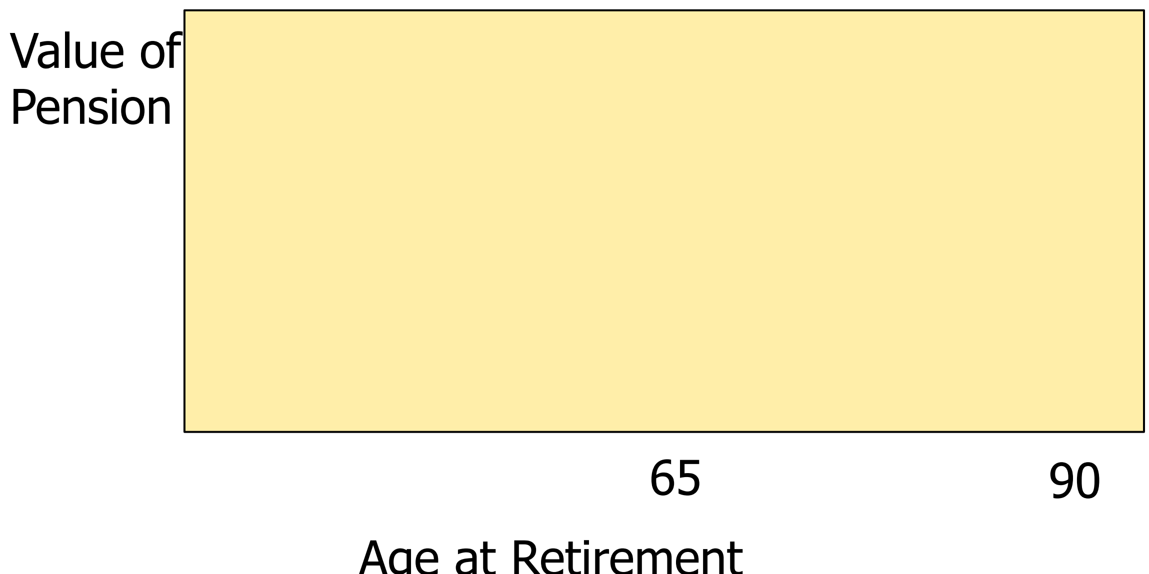
      = 0.025 * (Years of Service) * (Average of 36 months of highest compensation)

Vesting and Portability

- A vested pension is one where worker must work x years at the firm before becoming eligible
  - Typical vesting period is 5 years
- Portability refers to whether the pension you have accrued at one firm can be taken and applied to another.
  - Rare except for social security and pension funds run by unions for, e.g., plumbers

4) How can features of pensions affect turnover?

- Defined benefit plans encourage retirement by certain date
  - (Pension payable only until death so its present value falls if wait to long to retire)
- Defined contribution plans can encourage people to work much longer as value continues to grow as long as work



4) How can features of pensions affect turnover? (2)

- Vesting of pensions encourages workers to stay at firm until their pensions vested
  - At start of year 5 present value of pension jumps up from 0

- A good way of reducing turnover among workers with fewer years worked at the firm