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 \times \text{Years of Service}
  - Common in blue collar jobs and unionized occupations

- Conventional or Formula Plan
  - Benefit = G \times (\text{Years of Service}) \times (\text{Average of Highest Compensation Earned})
  - Example: At UCSD, for a 65 year old, monthly retirement income
    - = 0.025 \times (\text{Years of Service}) \times (\text{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 too 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

![Present Value of Pension](chart)

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<th>Number of Years at firm</th>
<th>Present Value of Pension</th>
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