Sixth Edition

Employee Benefits

A Primer for Human Resource Professionals

McGraw Hill Education

Joseph J. Martocchio

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Joseph J. Martocchio
University of Illinois

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EMPLOYEE BENEFITS: A PRIMER FOR HUMAN RESOURCE PROFESSIONALS, SIXTH EDITION

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For My Students

—Joseph J. Martocchio

About the Author

Joseph J. Martocchio *Professor in the School of Labor and Employment Relations, University of Illinois at Urbana-Champaign*

Professor Martocchio earned his Bachelor of Science degree in management and quantitative methods from Babson College, and both his Master's and PhD degrees in human resource management from Michigan State University's School of Labor and Industrial Relations. His research and teaching interests include employee compensation, employee benefits, and employee training and development. Professor Martocchio's research appears in leading scholarly journals including the *Academy of Management Journal, Academy of Management Review, Journal of Applied Psychology, Journal of Management,* and *Personnel Psychology*. He has researched extensively, placing him in the top 5 percent of the most productive researchers published in premier applied-psychology journals in the 1990s, according to a survey conducted by the Society for Industrial and Organizational Psychology (SIOP). Professor Martocchio received the Ernest J. McCormick Award for Distinguished Early Career Contributions from the Society for Industrial and Organizational Psychology (SIOP), and was subsequently elected as a Fellow in both the American Psychological Association and SIOP. Following the attainment of this recognition, he served as the Chair of the HR Division of the Academy of Management as well as in various other leadership roles within that organization. He is the author of the textbook *Strategic Compensation: A Human Resource Management Approach* (Pearson Higher Education) and coauthor of a textbook with Wayne Mondy, *Human Resource Management* (Pearson Higher Education).

Preface

Employee benefits refer to compensation other than hourly wage, salary, or incentive payments. Three fundamental roles characterize benefits programs: protection, paid time off, and accommodation and enhancement. *Protection programs* provide family benefits, promote health, and guard against income loss caused by catastrophic factors such as unemployment, disability, and serious illnesses. *Paid time-off* policies compensate employees when they are not performing their primary work duties, for example, vacation and holidays. *Accommodation and enhancement benefits* promote opportunities for employees and their families, including stress management classes, flexible work arrangements, and educational assistance.

Employee Benefits was written to provide an introduction to the most common employee practices used in U.S. firms. It is an appropriate source of information for those who want to learn the foundation and acquire a breadth of knowledge about these practices. College-level students taking an undergraduate or a graduate course in employee compensation and benefits will build the foundation for understanding the origin of specific benefits practices and fundamental design considerations. Practitioners who work with benefits professionals or are beginning to take on administrative or managerial roles regarding employee-benefits programs will find this book to be an excellent introduction.

This book contains 12 chapters, organized into four parts:

- Part 1: Introduction to Employee Benefits
- Part 2: Retirement, Health Care, and Life Insurance
- Part 3: Services
- Part 4: Extending Employee Benefits: Design and Global Issues

Each chapter contains a chapter outline, learning objectives, key terms, discussion questions, and two brief cases.

NEW TO THE SIXTH EDITION

All the chapters have been thoroughly revised to capture the ever-changing field of employee benefits—and this field changes at a breakneck pace! For instance, the Patient Protection and Affordable Care Act has imposed an employer mandate for offering health-care plans to employees and compliance guidelines. The Dodd-Frank Act requires even greater transparency of executive benefits practices. Although both laws were passed a few years ago, the implementation requirements have rolled out in phases. In addition, for those who will work with benefits practices in other countries, concepts and data have been added to help make cross-country comparisons. Further, substantially more statistics are included to quantify the costs and prevalence of particular benefits as well as trends where available. All statistics were the most current at the writing of this edition. Finally, thanks to feedback from my students, course instructors, and practitioners, substantial rewriting throughout the book better organizes and breaks down the complexity of benefits practices for the book's intended readers.

SUPPLEMENTAL MATERIALS FOR INSTRUCTORS

All supplements are available from the book's Web site at www.mhhe.com/martocchio6e. Given the rapid and substantial changes in the benefits area, the Web site also offers updates to text coverage of important benefits topics and issues.

Instructor Supplements: Instructor's Resource Manual, TestBank, and PowerPoint Presentations.

ACKNOWLEDGMENTS

Many people made valuable contributions. I am also indebted to the reviewers who provided thoughtful remarks for the development of the sixth and previous editions: Among them are James C. Coulson from Chapman University; Larry Morgan from St. Mary's University; Lori Olson from Western Technical College; Barbara Rau from the University of Wisconsin, Oshkosh; Joel Rudin from Rowan University; and Carol Spector from the University of North Florida. F. Jack Witt III, Vice President of Human Resources and Administration at Owens Community College, provided meticulous comments that draw not only from his extensive field experience, but also from his expertise teaching an employee-benefits course at Wayne State University.

At McGraw-Hill Higher Education, my gratitude goes to Michael W. Ablassmeir and Laura Hurst Spell for their support and commitment to this project. I thank Kelly Hart for her oversight of this project. At Lumina Datamatics, I thank Srinivasan Sundararajan for his fine work during the final stages of this project.

Joseph J. Martocchio

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Part One

Introduction to Employee Benefits

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Chapter **One**

Introducing Employee Benefits

Chapter Outline

Defining and Exploring Employee Benefits

Defining Employee Benefits

The Fundamental Roles and Sources of Employee Benefits

Employee Benefits in the Total Compensation Scheme

The Field of Employee-Benefits Practice

Legally Required Benefits

Discretionary Benefits

Origins of Employee Benefits

Legal and Regulatory Influences on Discretionary Benefits Practices

Strategic Planning for a Benefits Program

Basic Strategic Planning Concepts

Approaches to Strategic Benefits Planning

Information Used in Strategic Benefit Planning

External Environment

Internal Environment

Key Terms

Discussion Questions

Cases

1. *Understanding Your Employee Benefits: Understanding a Job Offer*
2. *Managing Employee Benefits: Strategic Benefit Planning at Makers Crafts*

Endnotes

Learning Objectives

In this chapter, you will gain an understanding of:

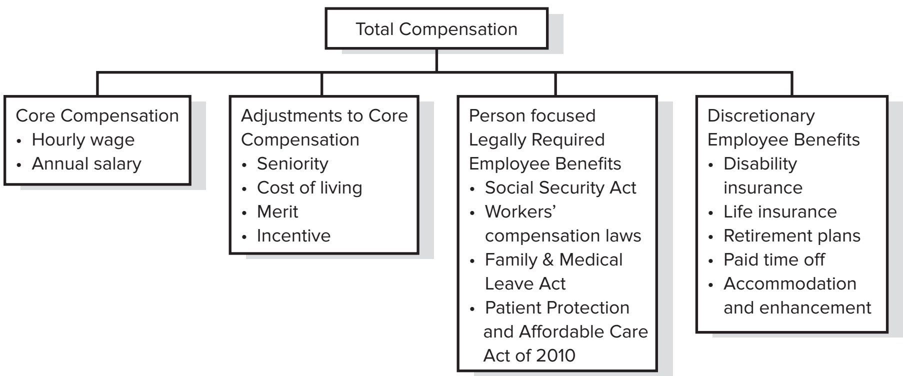
1. The fundamentals of employee benefits and fit in the total compensation scheme.
2. The field of employee-benefits practice.
3. Legal and regulatory influences on discretionary employee-benefits practices.
4. The strategic importance of benefits and approaches to strategically planning a benefits program.
5. Information used to develop strategic benefits plans.

Welcome to *Employee Benefits: A Primer for Human Resource Management Professionals*. Understanding employee-benefits practices is a worthwhile endeavor no matter whether you plan to become a specialist working in an employee-benefits department, a human resource generalist, or a manager in any department. For instance, employee-benefits professionals are experts in paid time-off policy design. These experts work with HR generalists who oversee all HR activities for employee groups and share developments in the employee-benefits offerings. Employee-benefits professionals also work with managers who are ultimately responsible for carrying out HR policies such as approving paid time off or knowing when to encourage a distressed worker to seek help through an employee assistance program. Let's not forget, most people work for a living and either currently have or will likely have access to at least one employee benefit. As a bonus, this book will help you to understand the components of your benefits and the employer's rationale for offering them.

DEFINING AND EXPLORING EMPLOYEE BENEFITS

Let's start off with a brief definition of employee benefits. Next, we put employee benefits in the context of total compensation systems in companies (Exhibit 1.1) and from there expand the definition of employee benefits. Finally, we examine strategic considerations essential for establishing and maintaining effective employee-benefits programs.

EXHIBIT 1.1
Employee Benefits in the Total Compensation Scheme



Defining Employee Benefits

Employee benefits refer to compensation other than an hourly wage or salary. Examples of specific employee benefits include paid vacation, health-care coverage, tuition reimbursement, and many more. To organize the vast amount of benefits information efficiently, it is helpful to group benefits based on the role that the benefits serve for recipients and the source of the benefits.

The Fundamental Roles and Sources of Employee Benefits

Three fundamental roles characterize benefits programs: protection, paid time off, and accommodation and enhancement. **Protection programs** provide family benefits, promote health, and guard against income loss caused by catastrophic factors such as unemployment, disability, and serious illnesses. **Paid time-off** policies compensate employees when they are not performing their primary work duties under particular circumstances such as vacation or illness. **Accommodation and enhancement benefits** promote opportunities for employees and their families. Employers may choose to offer one or more of these benefits, including wellness programs, flexible work schedules, and educational assistance.

Employee benefits derive from two broad sources. First, the U.S. federal government requires that most employers, employees, or both make contributions so that certain government-sponsored benefits can be provided to employees. These are referred to as *legally required benefits*. Laws such as the Social Security Act of 1935 mandate a variety of programs designed to provide income to retired workers, disability income, survivor benefits, and health care for older Americans. Legally required benefits can take other forms such as workers' compensation insurance, which the employer purchases and administers. And, it should be noted that some cities and states have legislation that enhance federal government benefits such as paid sick leave. Second, companies may choose to offer additional benefits such as educational benefits and retirement savings plans as just two examples. Choice benefits are referred to as *discretionary benefits*.

Exhibit 1.2 lists typical employee benefits offered in U.S. companies. As this exhibit shows, legally required benefits focus on protection, and companies may choose to offer additional protection programs, which often enhance or supplement legally required benefits. For instance, discretionary disability protection, when added with Social Security disability insurance, could generate a higher income stream than would otherwise be possible.

Prior to the passage of the Patient Protection and Affordable Care Act of 2010, which mandates that most companies provide health-care coverage, companies offered health-care benefits on a discretionary basis. However, some companies still treat health care as a discretionary benefit. In lieu of offering health-care benefits, they are willing to pay a penalty to the federal government based on provisions of the law. More recently, it is possible that employer-sponsored health care will return to discretionary benefit status because President-elect Donald Trump has promised to seek the law's repeal.

Employee Benefits in the Total Compensation Scheme

Employee benefits are a part of a company's total compensation system. **Total compensation** represents both core compensation (wages, salaries, and adjustments), and

EXHIBIT 1.2
Typical Employee Benefit Offerings in the United States

Legally Required Benefits

- Old-Age, Survivor, and Disability Insurance (OASDI)
- Health-care coverage
  - Prescription drugs
  - Mental health and substance abuse
  - Maternity care
- Medicare
- Unemployment insurance
- Workers' compensation
- Family and Medical leave

Discretionary Benefits

Protection Programs
- Dental care
- Vision care
- Life insurance
- Disability insurance (short- and long-term)
- Retirement programs

Paid Time Off
- Holidays
- Vacation
- Sick leave
- Personal leave
- Bereavement or funeral leave
- Sabbatical leave
- Jury duty and witness duty leaves
- Military leave
- Nonproduction time
- Volunteerism

Accommodation and Enhancement Programs
- Employees' and family members' mental and physical well-being
- Employee assistance programs
- Wellness programs
- Family assistance programs
- Educational benefits for employees
  - Educational assistance programs
  - Tuition reimbursement programs
  - Scholarship programs
- Support programs for daily living
  - Transportation services
  - Physical fitness

employee benefits represent compensation other than wages or salaries (see Exhibit 1.1). Compensation professionals establish core compensation programs to reward employees according to their job performance levels or for acquiring job-related knowledge or skills. Monetary compensation lies at the heart of core compensation. After briefly defining specific core and employee-benefits practices, we will subsequently discuss the origins of employee benefits. Understanding the origins enables employee-benefits professionals to better understand the rationale for benefits design.

Core Compensation

Employees receive **base pay**, or money, for performing their jobs. Companies disburse base pay to employees in one of two forms. Employees can earn an hourly pay, or a wage, for each hour worked, or they can earn a salary for performing their jobs, regardless of the number of hours worked. Companies measure salary on an annual basis.

Adjustments to Core Compensation

Over time, employers may choose to adjust employees' base for one or more reasons: increases in the cost of living, differences in employees' job performance, or differences in employees' attainment of job-related knowledge and skills. These elements are defined next.

Cost-of-living adjustments (COLAs) represent periodic base-pay increases often set to periodic changes in the U.S. Bureau of Labor Statistics' Consumer Price Index (CPI). COLAs enable workers to maintain purchasing power by having their base pay adjusted for inflation. Over time, most everything we buy costs more money, such as the price of a gallon of milk. Most companies choose not to apply COLAs to base pay. However, this practice is a common feature in the unionized workforce and in government employment.

How exactly does inflation affect purchasing power? Let's assume, for example, that a local grocery store employs college students, paying them $11 per hour. Let's also assume that a student works 10 hours per week, for a total of $110. Further, let's assume a student typically drives his car, paying $20 per week for gasoline. As gas prices rise, the weekly gasoline cost could increase to $30. As long as the hourly wage rate remains the same, the student will have 10 fewer dollars available for other pursuits. Rising costs erode purchasing power when wages do not increase accordingly.

Seniority-pay systems reward employees with periodic additions to base pay, according to length of service. Over time, employees presumably refine existing skills or acquire new ones that enable them to work more productively. This rationale comes from human capital theory, which states that employees' knowledge and skills generate productive capital, known as human capital. A person employed in a company for a long time knows rules and procedures from which he or she develops the skills (i.e., human capital) necessary to perform a job more quickly than newly hired employees. Today, most unionized private-sector and public-sector organizations continue to base salary on seniority or length of employee service, though the number of unionized workplaces is steadily declining. In 2015, the overall unionization rate was 11.1 percent. During the same period, unionization in the private sector was 6.7 percent and 35.2 percent in the public sector. Members of union-bargaining units whose contracts include seniority provisions, usually rank-and-file as well as clerical workers, receive automatic raises based on the number of years they have been with the company. In the public sector, most administrative, professional, and even managerial employees receive such automatic pay raises.[1]

Merit-pay programs assume that employees' compensation over time should be determined based on differences in job performance. Employees earn permanent increases to base pay according to their performance, which rewards excellent effort or results, motivates future performance, and helps employers retain valued employees. Merit pay increases are expressed as a percentage of current base pay, with higher percentage increases for better performers. For instance, an employee currently earning $25,000 annually receives a 10 percent merit pay increase, making her total annual pay $27,500 after the pay raise takes effect: [$25,000 + (10 percent of $25,000 = $2,500)]. In 2016, employees earned average merit increases of 3.0 percent across all industries, and the projected average increase for 2017 was 3.1 percent.[2] This average increase did not vary significantly, except for nonexempt hourly employees whose average merit increase was 2.9 percent in 2016. In addition, most companies relied on market-based pay increases. Most U.S. companies rely on merit pay to recognize employee performance.

Incentive pay rewards employees for partially or completely attaining a predetermined work objective. Incentive pay is defined as compensation other than base wages or salaries that fluctuates according to the attainment of individual or group goals (for example, $1,000 to a customer sales representative whose customer-service ratings increased each month over a six-month period), or company earnings (for instance, employees share 2 percent of company profits when the company substantially exceeds its performance projections). Commonly used incentive plans include piece rate, gain sharing, and profit sharing.

Person-focused pay rewards employees for acquiring new knowledge and skills through designated curricula sponsored by an employer. This approach recognizes the range, depth, and types of skills or knowledge employees are *capable* of applying productively to their jobs following training. This feature distinguishes pay-for-knowledge plans from merit pay and incentive pay, which reward actual job performance. Some targeted studies and anecdotal information suggest that companies of various sizes use person-focused pay programs. Many of the companies known to be using this kind of pay system employ between approximately 150 and 2,000 employees, the majority operate in the manufacturing industry, and the average age of the companies is approximately 10 years.[3] Overall, the pay method is least commonly used among all U.S. companies, in part because companies fear training employees to join the competition later.

THE FIELD OF EMPLOYEE-BENEFITS PRACTICE

Virtually every company offers at least one benefit to employees, and most companies offer several. This book emphasizes the importance of benefits in achieving legal compliance and competitive advantage and how companies achieve these goals. Meeting these imperatives requires benefits professionals who work in departments within the broader human resource function or as external consultants offering expert advice. Employees in benefits departments span the organizational hierarchy, including clerical staff members, managerial employees, and executives.

One survey revealed that the typical number of employees working in a company's benefits department is 5.3, of whom 3 are professional or managerial staff and 2.3 are support or clerical staff.[4] In addition, the number of staff members varied by company size, ranging from an average of 2.9 employees in smaller companies to 11.3 in larger companies.

So, with which issues do employee-benefits professionals work? According to the *Occupational Outlook Handbook*:

> Benefits managers plan, direct, and coordinate retirement plans, health insurance, and other benefits that an organization offers its employees.[5]

Performance standards are established by members of the profession rather than by outsiders. Most professions also have effective representative organizations that permit members to exchange ideas of mutual concern. Several well-known organizations serve the benefits profession. Among the more prominent are the International Foundation of Employee Benefit Plans and WorldatWork.

Opportunities for employment as compensation and benefits managers are projected to grow at an annual rate of 6 percent through 2024.[6] The median annual compensation for compensation and benefits managers was $108,070, which is more than double the median annual earnings for all jobs.[7] The salary levels vary on a number of factors, including relevant work experience, educational credentials, and industry. For example, the mean annual compensation was lowest in local government ($95,880) settings and highest in the financial securities industry ($158,760).

While the employee-benefits group is on the same team as HR, inevitably tensions arise. Employee-benefits professionals are inclined to develop the benefits program, but competition for limited funds creates challenges. For instance, recruitment professionals may wish to purchase costly selection tests to improve the quality of hires. Training and development professionals vie for greater resources to incorporate expensive technology into curricula. Let's take a closer look at the components of benefits packages to gain an appreciation of the scope of employee benefits.

Legally Required Benefits

Legally required benefits are mandated by several laws, some of which include: the Social Security Act of 1935 (Chapter 7), various state workers' compensation laws (Chapter 6), the Family and Medical Leave Act of 1993 (Chapter 8), and the Patient Protection and Affordable Care Act of 2010 (Chapter 5). All provide protection programs to employees and their dependents. A basic summary of each benefit follows, with detailed treatment deferred to the relevant chapters.

The Social Security Act of 1935

The economic devastation of the Great Depression era prompted the federal government into action because most people had used up their life savings to survive, and opportunities for gainful employment were scarce. **The Social Security Act of 1935** set up two programs: a federal system of income benefits for retired workers, and a system of unemployment insurance administered by the federal and state governments. Amendments to the Social Security Act established the disability insurance and Medicare programs. **Old-Age, Survivor, and Disability Insurance (OASDI)** refers to the programs that provide retirement income, income to the survivors of deceased workers, and income to disabled workers and their family members. **Medicare** serves nearly all U.S. citizens aged at least 65, as well as disabled Social Security beneficiaries, by providing insurance coverage for hospitalization, convalescent care, major doctor bills, and prescription drug coverage.

State Compulsory Disability Laws (Workers' Compensation)

Workers' compensation insurance came into existence during the early decades of the 20th century, when industrial accidents were very common and workers