Direct Versus Indirect Compensation: Balancing Value and Cost in Total Compensation

By: Vas Taras

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Abstract:

The effect of compensation on employee performance, satisfaction and organizational commitment is hard to overstate. Designing an effective compensation structure may be a daunting task, in particular with respect of finding a balance between direct and indirect compensation. The paper discusses the challenges and offers best practices for incorporating non-monetary benefits in a compensation package.

Keywords: compensation | indirect compensation | benefits | compensation package design

Article:

Phil Osborne is a newly appointed CEO of TechSense (names changed), a medium-sized company based in Charlotte, North Carolina, that designs and produces data processors for small medical equipment such as heart rate monitors. Despite high unemployment in the state, TechSense has been struggling with a staff turnover almost twice the industry average. With the cost of recruiting, relocating and providing company-specific training approaching semiannual salary associated with the position, TechSense is losing hundreds of thousands of dollars every year to high turnover—and that's not taking into account the damage to the personnel morale and company image.

Shortly after moving to TechSense, Osborne ordered an employee survey. The results suggested that the cause of the high turnover, at least in part, may lie in a poorly designed compensation system. While TechSense offers a generous compensation package, well above industry average, indirect benefits comprise a substantial portion of the package, leaving a rather modest direct compensation component. Given the comparatively low base salary, compensation satisfaction among TechSense employees is low. With the critical effect of compensation satisfaction on commitment, motivation and ultimately performance, the problem cannot be ignored—and Osborne is determined to fix the problem.

Redesigning a compensation structure is an intricate task. Finding a balance between direct monetary compensation and indirect benefits and deciding on what benefits, if any, should be included in the package is a challenge. On one hand, direct compensation, such as salary, wage or commissions, is the single best predictor of compensation satisfaction—and often of job satisfaction, effort and performance. Examples of successful companies that offer higher monetary pay at the expense of low benefits are numerous. Lincoln Electric, perhaps the most known and celebrated no-benefit company, is a producer of welding equipment. It offers absolutely no benefits beyond those mandated by law but instead keeps the level of monetary compensation well above industry average. This Spartan system, harsh by many standards, allowed the company to maintain high retention rate and personnel morale even in the toughest times.

On the other hand, with the portion of indirect compensation in the total compensation package constantly rising, a no-benefit compensation may be perceived by employees as a lack of appreciation and greediness on the side of employer. Not surprisingly, some of the most successful companies with remarkably low turnover rates are known for the lavish benefits included in their compensation systems. For example, SAS and Google treat their employees like, what many call, royalty. On-campus gyms and swimming pools, company doctors and masseurs, subsidized cafeteria and day care and country club memberships are just a few examples of the benefits received by their employees. While the monetary component in the total compensation package at SAS or Google is not particularly high by the industry standards, the employees there do not seem to be asking for more cash instead of benefits.

What many fail to recognize is that indirect benefits are not "extras" on top of the main compensation package but part of the pay. The money companies spend on providing indirect benefits to their employees could be used instead to increase the direct pay. That is, benefits are a substitute for a portion of the monetary compensation. And that portion is quite substantial.

On average, American companies spend up to 40% of payroll on various benefits, such as health benefits, recreating, retirement plans and various perks. With the cost of health care and medical insurance on the rise, the cost of benefits, as well as their percentage in the payroll budget, has been increasing in the past few decades rather rapidly, roughly 4% annually, though the jumps have been much higher in some years, notably the spike of almost 10% in 2004.

What many employees fail to recognize is that any benefit, perhaps expect for those required by law, could be offered in a form of additional monetary compensation. A 40% increase in salary, how is that for a compensation package improvement?

Of course, no one would argue that benefits should be abandoned altogether in favor of a direct compensation increase. The question is when do benefits make sense and when is offering cash equivalent more feasible?

Incorporating Benefits in the Compensation Package

First, let us review some basics. Not all benefits are valued equally by the employees. It makes sense to offer only those benefits that the employees truly need, while opting for an increase in monetary compensation instead when the employees may find a particular benefit less valuable. For example, an on-site child day care may not be a valued option in work groups consisting of older employees whose kids are likely to be past the day care stage. Alternatively, elder care subsidy may not be a valued benefit in younger work groups consisting of recent graduates.

It is true that cash offers ultimate flexibility and thus is generally preferred over benefits, even most valued ones. In cases when the benefit could be purchased at the same price via an external provider, direct compensation increase is an obvious preferred choice. For example, tuition reimbursement may be highly valued by younger employees. However, if offered an equivalent pay increase, the employees interested in the benefit would still be able to pursue the education advancement option by simply offsetting the cost of tuition from their increased pay.

Nevertheless, even though it may appear that monetary compensation would always be preferred to benefits, there are several expectations when benefits make more sense. Let us review each of these cases separately.

Group Rates

Benefits rather than extra cash should be offered if the benefits could be purchased at lower group rates through the company. The best example is health insurance. A health insurance plan purchased at a company group rate may be substantially cheaper than a comparable package purchased individually. Therefore, it would make no economic sense to offer employees a salary increase equivalent to the group rate of the health insurance provided by the employer. The cash used to purchase the plan using group rates simply will not buy the same package individually.

Group rates could also be negotiated for other forms of insurance, such as life or auto, as well as group club and gym memberships, recreation area and amusement park fees, subscription rates, public transit pass rates and many more—each saving the employee money and effectively increasing the value of the total compensation package. For example, colleges and large companies often get group rate discounts for their employees and students from the local public transit authorities. While it is generally required that all eligible recipients subscribe to the service, the savings are great—often amounting to hundreds of dollars annually—and could not be attained without the involvement of the employer.

Economies of Scale

The economies of scale refer to a decrease in marginal cost (cost per additional unit) of a product or service due to an increase in the number of products or service units provided. In other words, it is a decrease in cost of each additional unit due to an increase in volume.

It makes sense to offer benefits, rather than an increase in direct compensation, when economies of scale could be achievable by offering the benefit to a large group of employees, rather than having each individual employee take care of the need individually. For example, it may be economically beneficial for large organizations to offer food services to their employees as a part of the compensation package. Everyone needs lunch. Buying lunch at a nearby restaurant may be costly, but preparing lunch individually is not much cheaper if the time and inconveniences associated with it are taken into account. The cost of preparing and serving lunch can be greatly reduced if food services were offered on a large scale.

By operating an internal cafeteria or even by outsourcing the service to an external caterer, large organizations can substantially reduce the cost of meals to their employees. Thus, it would make sense to reduce monetary compensation by the amount equivalent to the cost of offering food services. The savings would outweigh the drop in base pay and thus the employees will be left with more money at the end of each pay cycle.

As an example, consider an employee who works for a large company and spends \$8 per lunch 5 days a week to a total of about \$160 per month. A company with several hundred employees can easily reduce the per-employee cost of lunch by 25% or so, which would lead to a saving of $40 per month or $480 a year for each employee. Furthermore, the saved time and added convenience could improve satisfaction and productivity.

Cost Sharing

Many products and services can be shared by several employees without sacrificing quality and convenience, thereby reducing the cost of the product or service to each of the participating individuals. Unfortunately, it is often too difficult for a group of strangers to set up and maintain a product- or service-sharing system, but it would be easier to do among individuals belonging to the same organization.

Employees may be offered car sharing, shared periodicals or online service subscriptions, retail chain memberships or national park passes as a part of their compensation package. For example, employees of companies headquartered nearby national parks or sky resorts likely visit these amenities on a regular basis. The annual passes could be costly, but the cost could be substantially reduced if it is shared by a group of individuals. In many cases, membership is not personalized and could be shared, and often service providers have special shared membership rates. Given that most membership holders use their passes only one or two times per month, the pass can be shared among a group of families without compromising individual schedules and convenience.

Thus, the employer may offer the benefit of the park pass by buying one for a group of interested employees and splitting the cost among them. The same goes for retail chain memberships such as Costco's or Sam's Club's and the like. With three to five families sharing the pass, it would not create major inconveniences but could save each family up to $100 or more, depending on the price of the pass or membership.

On-site Convenience

Even if offering the benefit via the company is not cheaper due to group rates or economy of scale, it may still make sense to offer the benefit rather than a monetary equivalent if the benefit offers on-site convenience. For example, a company-operated gym or day care may not be any cheaper than those offered by external providers. Even though an increase in monetary compensation may appear as a preferred option as it gives the employee a choice of provider, the savings in time and reduced stress due to the convenience of having access to the service on-site is likely to overweigh the benefits of choice.

On-site programs offered as compensation package benefits can save an hour or more of daily commute, leading to a saving of 20 hours or more monthly. Assuming the time could be spent on activities that are more meaningful to the employee, including extra work for extra pay, and factoring in the cost of gas and vehicle depreciation, the savings can easily translate into several hundred dollars a month.

What may be even more important is that on-site program availability encourages participation, which is especially important for health-related and recreational programs. For example, having access to a gym right by your office does not leave an excuse for missing a workout and is likely to lead to a healthier lifestyle of the employees. This would translate in fewer sick days and increased productivity.

Furthermore, on-site availability not only encourages participation but also saves time and stress. For example, many larger companies, in particular those located in remote areas, may benefit from an in-residence general physician office. While the cost of running the facility may be high, the employees could see a doctor and be back at their work desk in minutes, whereas a regular doctor visit may take a few hours of (often paid) work time.

Value to Employee Greater Than Cost to Employer

Many benefits and perks often have a much greater value to the employees than the cost to the company. For example, allowing an employee to use a company vehicle for private purposes would be costly for the company. But using a company vehicle for personal purposes could allow the employee to opt from owning a personal car. The savings in insurance, loan interests and other expenses associated with owning a vehicle to the employee may be much greater than the cost to the employer. Thus, reducing the employee's pay by the amount that it costs the company to offer the benefit of the opportunity to use the vehicle for private purposes saves the employee more than the reduction in direct pay and thus effectively translates to an increase in total compensation.

Furthermore, it is likely that such a policy would lead to a more gentle use of company vehicle fleet, which is likely to reduce maintenance cost. Similarly, company cell phones that normally have unlimited talk/data plans or laptops could be allowed for unrestricted private use. The added cost associated with faster depreciation is likely to be minimal and could be deducted from the employee pay at the benefit of much greater savings due to the removed need to own these gadgets.

Along the same lines, payday loans are not only a growing business worldwide but also a new trend in the corporate world. Small short-term loans "until the payday" often are the only way to deal with temporary financial problems. Payday lender typically charge 15% for a 2-week advance, which is roughly equivalent to a 400% annual rate. Most companies have some cash on their accounts. Lending the money to their employees as a short-term payday loan at the price of the interests on the deposit the company loses by advancing the money, plus perhaps some processing fee, could save a substantial amount of money to the employee in need, while not costing anything to the company.

The risks to the company are also minimal as the employee works for the company and most certainly will continue doing his or her job until the payday, when the company can simply deduct the amount of the payday loan form the employee's paycheck. The company can even make some money by charging the employee interest that is higher than what the company gets on its term deposits; and as long as the interest rate is lower that of the payday lenders, the employee still saves and effectively sees his pay increased—not to mention the likely positive effect this practice would have on organizational commitment and retention and the related savings and profits for the organization.

Legal Tax Savings

Often it is possible to save money for employees by moving part of the compensation package into the benefits category. For example, flexible spending accounts are an example of many tax-advantaged financial accounts commonly used in the United States and other countries. Most common flexible spending accounts allow for putting aside money for medical expenses, child and elder care or cafeteria. The funds are used pretax and save up to a quarter of the amount depending on the employee's income tax bracket.

Depending on the tax regulations in the specific jurisdiction, it may be possible expand the list of options beyond standard flexible spending accounts and cover other regular expenses that employees are likely to encounter on a regular basis, in particular those that could be justified as operation expenses. For example, subscriptions to professional periodicals, cost of recreation, stress-relieving programs and tickets to various events could often be covered by the employer from pretax accounts, which translates into substantial savings for employees who otherwise would have to cover the expenses using their posttax income.

In some countries, such as the United Kingdom, Australia, New Zealand, Pakistan or India, fringe benefits are taxed separately, which leaves limited opportunities to save on taxes this way. But the rules are much less restrictive in most countries, which offers an opportunity to increase the real value of the compensation package by 20% to 25% particularly in countries where personal income tax is high.

Benefits Critical To Creativity, Quality and Sustained Performance

Sometimes it makes sense to offer a benefit even if by doing so no money or time will be saved and no convenience added, but the benefit is essential for sustained high performance and when it is in the company's interest to encourage employee participation in the program. For example, a company may choose to include tuition and training fee reimbursement if continued learning is essential for the position. While the cost of a training course could be simply added to the employee's compensation, this will not guarantee that the employee will actually take the course and therefore adding tuition reimbursement as an indirect benefit may be a strategically better decision.

The same applies to health and recreation benefits. For example, for stressful and demanding positions regular exercising and recreational activities may be critical to maintain high productivity and avoid health-related absenteeism. Offering gym membership as a benefit may be preferred to offering an equivalent increase in direct compensation if there is a concern that the extra monetary pay will not be used on healthy lifestyle.

Similarly, it may be preferred to offer programs that improve productivity by stimulating creativity, reducing stress or encouraging idea exchange and learning as benefits rather than offering an increase in direct compensation equivalent to the cost of the programs. For example, as creativity is critical to success of companies specializing in idea generation and unconventional solutions, SAS employs several artists in residence whose job is to create and manage the many pieces of art scattered throughout the SAS campus to stimulate the creativity of its programmers and engineers.

Benefits That Motivate

Finally, some benefits may have a motivating effect and encourage performance more than could be expected from direct monetary compensation. Benefits related to profit sharing, stock options, bonuses, gift cards and vouchers that are tied to individual performance may not yield a higher income or savings but could be preferred as a performance-motivating tool. Of course, benefits of this type resemble commission and effectively offer the same advantages and disadvantages. On one hand, they are incentives to work harder. On the other hand, they can create a sense of pressure, stress and unhealthy rivalry among employees that, in the long term, can have a negative effect on organizational performance.

Furthermore, benefit-based motivators sometimes can shift performance focus from long-term organizational success to short-term financial performance, which is particularly of concern in stock option or profit-sharing cases. However, if the performance criteria are clearly articulated and tied to a thoughtfully developed set of performance measures, the motivation provided by the rewards can lead to a substantial improvement in motivation, effort, productivity and subsequently organizational performance.

To conclude, each of the benefits described above have a limited corresponding monetary value. However, if combined together they may well represent a saving of a few thousand dollars to both the company and the employee. The rules change the way we think about benefits. Benefits should not be treated as something the company pays for. It may well be something leading to savings that are shared between the company and employee.

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Bio

Vas Taras received his PhD in human resources (HR) and organizational dynamics from the University of Calgary, Canada, and his master’s in political economy from the University of Texas at Dallas. He teaches international business at the University of North Carolina at Greensboro. He conducts research in the area of management and development of human resources in multinational companies and domestic companies that employ immigrants. He also specialized in effectiveness evaluation of HR policies and programs. His publications have appeared in the Journal of Applied Psychology, Journal of International Business Studies, Journal of International Management, International Journal of Human Resource Management, Organizational Dynamics and other respected outlets. He is an associate editor of the International Journal of Cross-Cultural Management. Vas has lived, worked and studied in half a dozen countries and has experience as a manager, businessman and cross-cultural team and diversity management consultant.