

COURSE: REWARD MANAGEMENT

LECTURE 8: TYPES OF COMPENSATION

LECTURER: DR LUCY KARIMI KIRIMA

Lecture learning outcomes:

At the end of the lecture, you will be able to:

- i. Discuss the types of compensation
- ii. Examine concepts of wages
- iii. Explore theories of wage determination

TYPES OF COMPENSATION

Compensation could be defined as the reward of any work or service offered by an individual to any organization or institution. To some, compensation may reflect the value of their personal skills and abilities, while to others it may refer to be return on the educational qualification or the training they have acquired. To some, it may be their worth in specific role or a job, based on their qualification, training, skills and expertise that they possess. The form of compensation, the type of compensation and the disbursement pattern of the compensation thus they become a part of employment agreement.

Types of Compensation

Direct /Base Compensation

Direct compensation refers to the monetary benefits offered and provided to employees in return of the services they provide to the organization. The monetary benefits include basic salary, house rent allowance, conveyance, leave travel allowance, medical reimbursements, special allowances, bonus, provident fund/gratuity, etc. They are given at a regular interval at a definite time.

1. Basic Salary

Basic salary is the amount received by the employee in lieu of the work done by him/her for a certain period say a day, a week, a month, etc. It is the money an employee receives from his/her employer by rendering his/her services.

2. House Rent

Allowance Organizations either provide accommodations to its employees who are from different state or country or they provide house rent allowances to its employees.

3. Conveyance

Organizations provide for cab facilities to their employees. Few organizations also provide vehicles and petrol allowances to their employees to motivate them.

4. Medical Reimbursement

Organizations also look after the health conditions of their employees. The employees are provided with medi-claims for them and their family members.

5. Bonus

Bonus is paid to the employees during festive seasons to motivate them and provide them the social security. The bonus amount usually amounts to one month's salary of the employee. Businesses offer bonuses in many different ways. Some bonuses are based on profitable operations of the business and are paid at year-end. A common type of bonus may be offered to salespeople for selling a specific item. Another type of bonus plan, one that may be part of an employment agreement, pays managers if the yearly sales or profits reach a certain level.

6. Special Allowance

Special allowance such as overtime, mobile allowances, meals, commissions, travel expenses, reduced interest loans; insurance, club memberships, etc are provided to employees to provide them social security and motivate them which improve the organizational productivity.

7. Dearness allowance

The payment of dearness allowance facilitates employees and workers to face the price increase or inflation of prices of goods and services consumed by him.

8. City Compensation Allowance

City compensation allowance is paid to the employees in certain cities to compensate the cost of living. It varies from city to city & it is highest in metropolitan cities.

9. Incentives

Incentives and variable compensation can be among the most important drivers of individual performance. An incentive is something that motivates an individual for good perform.

Indirect /Supplementary Compensation

Indirect compensation refers to non-monetary compensation provided to employees in return of their services to the organization (naukrihub, 2014).

1. Leave Policy

It is the right of employee to get adequate number of leave while working with the organization. The organizations provide for paid leave such as, casual leaves, medical leaves (sick leave), and maternity leaves, statutory pay, etc.

2. Overtime Policy

Employees should be provided with the adequate allowances and facilities during their overtime, if they happened to do so, such as transport facilities, overtime pay, etc.

3. Hospitalization

The employees should be provided allowances to get their regular check-ups, say at an interval of one year. Even their dependents should be eligible for the medi-claims that provide them emotional and social security.

4. Insurance

Organizations also provide for accidental insurance and life insurance for employees. This gives them the emotional security and they feel themselves valued in the organization.

5. Leave Travel

The employees are provided with leaves and travel allowances to go for holiday with their families. Some organizations arrange for a tour for the employees of the organization. This is usually done to make the employees stress free.

6. Retirement Benefits

Organizations provide for pension plans and other benefits for their employees which benefits them after they retire from the organization at the prescribed age.

7. Holiday Homes

Organizations provide for holiday homes and guest house for their employees at different locations.

8. Flexible Timings

Organizations provide for flexible timings to the employees who cannot come to work during normal shifts due to their personal problems and valid reasons.

9. Profit Sharing Payments

A profit sharing plan, like a bonus plan, can be structured in a number of different ways. An employer may elect to pay cash to employees, give them stock in the business, or set up a deferred compensation fund for retirement.

Other Taxable Forms of Compensation

Sometimes other payments to employees are required that are equivalent to wages. These include non-cash fringe benefits, reimbursed expenses, sick pay, supplemental unemployment payments are subject to federal taxes.

Fringe Benefits

Fringe benefits are on-the-job benefits that come in a form other than money. Fringe benefits, sometimes called “perks,” are offered by some employers to some employees, usually for the purpose of enticing highly qualified individuals to accept or maintain employment at their companies. This type of non-wage benefit is something counted as taxable income, depending on the perk. “Benefits given to an employee in addition to his wages or salary.” Fringe benefits are a type of compensation provided to an employee outside of his normal wage or salary. Many years ago, employers began to understand that potential employees give great consideration to the wage or salary offered. In an effort to tempt a qualified individual to accept employment with the company, rather than going to a competing company, many employers began offering non-wage compensation in addition to the actual salary offered. These fringe benefits, often in the form of employer-paid life and health insurance policies, retirement benefits, and other things that might aid in the recruitment of top quality, skilled workers. In fact, fringe benefits play a large role in keeping workers motivated to do quality work and increase production. Some fringe benefits may be classified as taxable income by the IRS.

Types of Fringe Benefit

Many employers offer employees an array of fringe benefits in addition to their salaries. Also considered “job-perks,” these benefits cost employers, who pay for such perks, and are therefore considered a portion of the employees’ salaries on their books, even if the benefits are not in the form of money, such as bonuses. There are many types of fringe benefit, and which types are offered often depends on the type of employer, and value of the employee’s position.

Fringe Benefits Taxable

A person applying for, or accepting, a job that provides certain perks may ask himself “are fringe benefits taxable?” The answer depends on the type of fringe benefit offered, and the tax laws at the time. Many job perks are not required to be added into the employee’s taxable income at tax time, others are. The IRS provides a publication on employee fringe benefits, which is targeted at employers, though employees may benefit from it as well.

Non-Taxable Fringe Benefits

There are many types of non-taxable fringe benefits that may be offered to employees without increasing their tax burden. Some of the most common tax-free types of fringe benefit provided to employees by private and public businesses include:

Insurance Coverage

Insurance coverage is perhaps the most common fringe benefit provided to employees, though the structure of how insurance is paid for has changed in recent years. Insurance coverage may include employer-paid life insurance, health insurance, and short or long-term disability insurance. When an insurance coverage fringe benefit is offered, the employer most commonly shares the cost of premiums at a certain percentage, thus reducing the amount for which the employee is responsible. Of course, insurance coverage may be offered entirely at the employer’s expense. Some employers also offer health savings accounts to their employees, often matching the employees’ contributions to the plan.

Childcare Assistance

Childcare assistance is one fringe benefit that comes in handy for many families, and may increase attendance at work, as well as productivity. This is because parents have additional responsibilities in ensuring their children are well cared-for while they are at work. Many large employers are offering on-site childcare, either free of charge, or at a discounted price. This allows parents to concentrate on their work, knowing their children are close by, and being cared for. Some smaller employers, while unable to maintain an on-site daycare facility, offer a cost-share for daycare.

Physical Fitness

Some employers make it a priority to ensure their employees have access to gyms or fitness centers in order to promote a healthy lifestyle, which in turn increases attendance and productivity. Some companies maintain on-site fitness centers, where employees can work out on breaks or other off times, while others offer paid gym memberships, or memberships at a discounted price.

Education Assistance

Education assistance in the form of tuition reimbursement, or other assistance in adding to an employee's education or skillset, is one of the more popular types of fringe benefit offered by employers. Helping an employee gain new job-related skills or knowledge helps the company, as the employee is then able to work at a different level in his current position, or may become able to advance into new areas of the business. Education assistance perks often mean the employer will work around the employee's school schedule, and may pay all or part of his tuition, and may pay for books and other educational expenses. In many cases, the employer requires a commitment from the employee to remain employed at the company for a minimum period of time after successful completion of the education. This prevents individuals from taking advantage of this fringe benefit, then join another organization.

Reimbursed Expenses

Payments made to employees for travel and other necessary business expenses are taxable only if: The employee does not have to substantiate those expenses with receipts or other documentation. The employer advances an amount to the employee for business expenses and the employee does not return any unused amount. Travel and entertainment reimbursements, or other expense allowances, paid to an employee under a non-accountable plan are also included as wages. Under a non-accountable plan, the employee is given a certain amount of money toward expenses, but does not have to substantiate them or return any excess cash. Under an accountable plan, travel advances paid to the employee prior to travel in excess of substantiated expenses must be repaid to the employer within a reasonable and specified period of time.

It is key to note that, the compensation includes wages, salaries, financial and non-financial benefits. Wage and salary are the main components of compensation and all the workers and employees are getting wages or salaries. Only few of the workers and employees who are working in few of the industries and organizations are getting other financial benefits and non-financial benefits. Based on the nature of work, wages is fixed, but apart from nature of work, there are different factors such as time, required skills for work, efficiency, etc. will play significant role in fixation of wages and salaries. It is difficult task for the HRD to determine wages and salaries of workers and employees. In this regard, many of the theories were already propounded by many of the economic and management thinkers on wages and salary determination as under.

Compensation structure

Compensation structure consists of the various salary grades and their different levels of single jobs or groups of jobs. The term 'wage structure' is used to describe 'wage/salary relationships' within a particular grouping.

The grouping can be according to occupation, or organization, such as wage structure of craftsman (carpenters, mechanics, bricklayers, etc.) The wage structure or 'grade' is comprised of jobs of approximately equal difficulty or importance as determined by 'job evaluation. If the 'point' method of job evaluation is used, the 'pay-grade' consists of jobs falling within a range of points. If the 'factor comparison' plan is used, the grade consists of a range of evaluated wage rates (or

points, if the wage rates are converted to points). If the 'ranking' plan is used, the grade consists of a specific number of ranks. If 'classification' system is used, the jobs are already categorized into 'class' or 'grades.

So the term Compensation structure means the pattern or the break up of the salary paid to the employees in their respective organization. It is important to note that while determining the compensation structure of employees, it is not only the mathematics but other subjects such as biology and psychology play a major role in compensation determination. Biology, the increase in size or activity of one part of an organism or organ that makes up for the loss or dysfunction of another. Psychology, behavior that develops either consciously or unconsciously to offset a real or imagined deficiency, as in personality or physical ability. Hence compensation management is an integral part of the labor market characteristics in order to attract capable employees by respective organizations.

Determinants of the wage structure

1. Economic Determinants

In the labor market there commonly exists, known as Occupational Wage Differentials. The reason for its existence is that in different occupations require different qualifications, different wages of skill and carry different degrees of responsibility, wages are usually fixed on the basis of the differences in occupations and various degrees of skills.

Adam Smith explains occupational wage differentials in terms of :

1. Hardship, 2. Difficulty of learning the job, 3. Stability of employment, 4. Responsibility of the job, and 5. Chance for success or failure in the work. This is a theory of wage structure.

But his standards of worth are equally useful in explaining the complexity of wage structure decisions. The market value of an item is the price it brings in a market where demand and supply are equal. Use value is the value an individual buyer or seller anticipates through use of the item. Use value obviously varies among individuals and over time.

2. Job worth

These two concepts of worth and the concept of internal labor markets combine to explain important differences among employers in wage structure decisions. Organizations with relatively open internal labor Markets (organizations in which most jobs are filled from outside) make much use of market value. They also make much use of wage and salary surveys in wage structure decisions. Conversely, organizations with relatively closed internal labor markets (most jobs are filled from inside) emphasize use value. Their analysis of job worth relies more heavily on perceptions of organization members of the relative value of jobs.

3. Training

Training requirements of jobs in terms of length, difficulty, and whether the training is provided by society, employers, or individuals constitute a primary factor in human-capital

analysis and thus job worth. The interaction of ability requirements with training requirements can yield different job values depending on the scarcity of the ability required and the number of people who try to make it in the occupation and fail.

4. Employee Tastes

Employee tastes and preferences are another economic factor. People differ in the occupations they like and dislike. In like manner, occupations have nonmonetary advantages and disadvantages of many kinds.

Concepts of Wages

Minimum wage: Minimum wage is one, which may be sufficient to enable a worker to live in reasonable comfort having regard to all obligations to which an average worker would ordinarily be subject. Objective of minimum wage:

- i. To prevent exploitation of workers and secure a wage equal to work load.
- ii. To raise the wages in the industries where they are low, thus prevent sweating in industry.
- iii. To promote peace in industry by guaranteeing a wage rate this will enable them to meet their minimum requirements.
- iv. Raise the standards of living and efficiency of workers.

Fair wage

Industry wages are fair relatively in industry in general. Lower limit of fair wages must be the minimum wage for workers and upper limit will be the industry capacity to pay. However, between these two limits following factors have to be considered:

- i. The productivity of labour
 - ii. The prevailing rate of wages in the same or neighboring locality.
 - iii. The place of the industry in the economy.
 - iv. The level of national dividend and its distribution.
- Living wage

The living wage represented the higher level of wage and it would include all amenities which a citizen living in a modern civilized society could afford. The living wages should enable to male earner to provide for himself and his family the bare essential of food, clothing and shelter but a measure of frugal comfort including education for the children, protection against ill health requirement of essential social needs and a measure of insurance against the more important misfortunes including old age.

Theories of Wages and Salary Determination

Wage determination, apart from the statutory aspect, is influenced by different theories.

Subsistence Theory

David Ricardo (1772—1832) advocated the subsistence theory. In Ricardo's words, workers should be paid 'To enable them to subsist and perpetuate the race without increase or diminution'. The theory was based on the assumption that if the workers were paid more than 102 subsistence wage, their numbers would increase as they would procreate more and this would bring down the rate of wages. If the wages fell below the subsistence level, the number of workers would decrease, as many would die of hunger, malnutrition, disease, cold etc., and many would not marry, when this happened wages would increase again. In economics, the subsistence theory of wages states that, in the long run, wages will be reduced to the minimum level needed to keep workers alive.

Wages Fund Theory

This theory was developed by Adam Smith (1723—1790) on the assumption that wages are paid out of a predetermined fund of wealth, the surplus savings of the wealthy. This fund could be utilized for employing labourers for work. If the fund was large, wages would be high; if it was small, wages would be reduced to subsistence level. The demand for labour and the level of wages were determined by the size of the fund.

Surplus Value Theory

The surplus value theory of wages owes its development to Karl Marx (1818— 1883). According to this theory, labour was an article of commerce, which could be purchased on the payment of the 'subsistence price'. The price of any product was determined by the labour and the time needed for producing it. The labourer was not paid in proportion to the time spent on work, but was paid much less, and the surplus was utilized for paying other expenses.

Residual Claimant Theory

The residual claimant theory advocated by Francis Walker (1840- 1897), assumes that there are four factors of production/ business activity - land, labour, capital, and entrepreneurship. Wages represent the amount of value created in the production, which remains after payment has been made for all these factors of production. In other words, labour is the residual claimant.

Marginal Productivity Theory

This theory assumes that wages are based upon an entrepreneur's estimate of the value that will probably be produced by the last or marginal worker. In other words, it assumes that wages depend upon the demand for and supply of labour. Consequently, workers are paid what they are economically worth.

Bargaining Theory of Wages

This theory considers that wages are determined by the relative bargaining power of workers, trade unions and employers. When a trade union is involved the basic wages, fringe benefits, job differentials, and individual differences tend to be determined by the relative strength of the organization and the trade union.

Behavioural Theory of Wages

This theory was pioneered by several psychologists and sociologists, such as Marsh and Simon, Robert Dubin and Eliot Jacques. Based on their various research studies, we can identify the following areas of interest in behavioural theories on wages:

- a. The employee's acceptance of a wage level: Individuals believe in employment stability and prefer to stay on with the same organization, pacing with their salary level. There are, however, several other factors to be considered such as size and prestige of the company, trade unions' power in the organization, their level of knowledge and competencies, etc.
- b. The internal wage structure: Employees value internal pay equity. Moreover, some jobs are also command social status (such as the job of a journalist). Organizations design wages for different cross-sections of employees, while considering maximum and minimum wage differentials, norms of span or control and demand for specialized skill-sets. Balancing of wages with such internal equity also keeps employees more motivated.

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