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Difficult Choices in Total Compensation: Balancing Health Care Costs and Wage Increases

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ABSTRACT

This article describes an experiential exercise suitable for undergraduate or master's-level students. The goals of the exercise are for students to correctly apply health insurance concepts such as premium, deductible, co-pay, and coinsurance; to understand and explain the dilemma facing organizations in an environment of increasing health care costs and limited compensation budgets; to discern and apply the concerns of employees with varying demographic profiles to health care cost sharing; and to develop competency in calculating health care costs at the organizational level. Students receive a scenario in which they act as an employee representative and are asked to provide input on their company's total compensation decisions. The issues include wages versus health care costs, degree of health care cost sharing, and type of health care plan—all in the context of budget constraints.

INTRODUCTION

Health care benefit plans have become an increasingly complex issue that is important to both human resource professionals and line managers. The exercise described in this article helps students understand the terminology and issues surrounding health insurance, and apply that terminology to a real-life situation. Students are challenged to design a compensation plan that balances wages with health care benefits, and which takes into consideration the diversity of employee needs. The exercise has been conducted with undergraduate students in a human resource management course comprised of both HRM and business administration majors; however, it would be suitable for masters-level students as well.

LEARNING OBJECTIVES

The learning objectives for this exercise are presented below:

- To be able to correctly apply health insurance concepts such as premium, deductible, co-pay, and coinsurance.
- To be able to explain the dilemma that organizations face in an environment of increasing health care costs and limited compensation budgets.
- To be able to discern and apply the concerns of employees with varying demographic profiles to health care cost sharing.
- To develop competency in calculating health care costs at the organizational level.

DEFINITIONS

Surveys have found that fewer than half of all employees are familiar with common health benefit terms (Miller, 2007). Many traditionally-aged college students do not pay for their own health insurance (or sometimes even their own car insurance). Therefore, the first step in teaching about health care issues requires helping students understand the terminology of premium, deductible, co-pay, etc. (see Cutler & Baker, 2006).

- **Premium**: The cost of the insurance policy. The employer may simply provide access to a group health plan or may pay up to 100% for the employee and for all/part of a family policy.
- **Deductible**: The amount the employee must pay for medical services before the health care plan starts covering the cost.
- **Co-pay**: A flat fee charged each time the employee (or family member) has an office visit (or sometimes other medical services), regardless of the cost of the procedure.
- **Coinsurance**: The employee is responsible for paying a certain percentage of the total cost of care.
- **Out-of-pocket maximum**: The maximum amount the employee must pay toward health care annually.
- **Open enrollment period**: Annual time period during which the employee can change the type or amount of coverage or number of dependents.
- **Flexible spending accounts**: Accounts that permit an employee to set aside *pretax* earnings to pay for certain services like child care, insurance premiums, health care costs not covered by insurance, or over-the-counter medications. If the amount set aside in the account is not used annually, the employee loses it and it is turned over to the employer.

ISSUES IN HEALTH CARE

Human resource management students also need to understand the issues involved in providing health benefits, particularly the reasons for increasing health care costs and the methods of cost containment (see also Kaiser Family Foundation, http://www.kff.org/insurance/employer.cfm). Originally, medical insurance covered only catastrophic care (e.g., surgical, hospital), but it has now expanded to include ongoing health care such as doctor visits, physical therapy, and preventive care. The Mental Health Parity Act of 1996 also requires parity in health benefit coverage for mental health in employer group health plans with 50 or more employees (HR 1424; cited in Leonard, 2008). Companies also may provide dental and optical benefits.

Advances in technology, equipment, and treatments have also made health care more expensive. Health care costs have also increased due to more types of prescription drugs, more expensive drugs, more drugs that can be taken in combination without side effects, and more marketing (Caudron, 2002). In addition, some experts believe that we have received all the savings possible from managed care (Caudron, 2002). Between 2007 and 2008, total healthcare costs increased over 10% (Miller, 2008b); costs to employers increased over 6%, with more costs being borne by employees (Miller, 2008a). Costs increased 7.7% in 2006, while at the same time wages increased only 3.8% and inflation increased 3.5% (Perry, 2007). Even doctors complain about the cost of insuring employees. Fifty-one percent of Americans surveyed did not visit a doctor or fill a prescription for a known medical issue because of cost (Gurchiek, 2008).

The search for ways to contain costs has led to a managed care system in which claims are reviewed, specialist pre-approvals may be required, more procedures are conducted on an outpatient basis, and there is more home health care. Dissatisfaction with restrictions on the network of medical professionals available to a policy-holder has led to greater choice, but also greater cost. One goal of managed care has been to avoid unnecessary procedures and to encourage preventive care. More recently, due to the realization that most employees have little idea what treatments cost, employers have put in place initiatives to give employees more responsibility for health care cost decisions and to expose them to cost consequences of their care. "Cost sharing" is a strategy to shift costs from the employer to the employee, including a larger share of premium costs, higher deductibles, or increased co-pays and/or coinsurance (Caudron, 2002). In addition, employers may encourage employees to choose less expensive coverage, use spousal coverage from another company where possible, employ lower cost therapies, and take measures to manage care of chronic conditions.

A small but growing number of employers use High Deductible Health Plans with Health Savings Accounts (HSAs) to reduce costs and increase employee responsibility (McQueen, 2007). Briefly, these consumer-driven health plans allow both employers and employees to contribute (at annual limits) to tax-free accounts that the employee controls and that can accumulate, from year to year, funds not expended on health care. The deductible must be at least $1,150 for individuals and $2,300 per family as of 2009. These policies typically include an out-of-pocket maximum as well ($5,800 for an individual and $11,600 for a family as of 2009).

TOTAL COMPENSATION

In an introductory human resource management course, the topic of benefits typically follows the chapter on direct compensation (e.g., wages, incentive plans). This set of topics is introduced within the context of total compensation, meaning that all types of rewards to employees must be considered in determining the value that the employee receives from the employer. Monetary rewards include salary and performance-based pay, but also medical benefits, retirement, insurance, paid leave, legally required benefits such as Social Security, and a variety of other things.

In addition, non-monetary rewards should be considered. To a certain extent, these types of rewards can substitute for some forms of direct compensation. For example, preferred work assignments can compensate for lower monetary rewards. However, this type of substitution can only stretch so far. Additionally, employers have a limited budget for increases in monetary rewards, and this budget must be shared between benefits and wages. As benefit costs increase, particularly for health care, funds are less available for wage increases. To complicate things further, different employees have different preferences for wages verses benefits, depending in part on family status and related demographic characteristics.

Employers also need to consider comparisons to the labor market in order to remain competitive. It is relatively easy for employees to compare wages in the labor market. However, the value of health care benefits can be more difficult to assess, and employees may underestimate the costs of the health care benefits that they receive. They may not fully appreciate the value of their health care plan as compared to the plan provided by another employer. Employees may also be unaware of the level of employee cost sharing among competing employers in the labor market.

THE EXERCISE

After covering background terminology, discussing the current climate of increasing health care costs, and addressing the issue of total compensation, students are introduced to the exercise. This exercise does not address all the issues that exist in the arena of health care benefits. Its focus is to illustrate employee cost sharing options and their impact on total compensation.

For the exercise, students are given the case scenario, provided in Appendix A. It is based on a real-life example and reflects the experience of a small business. Given a limited budget to spend on compensation increases, the company needs to make a decision about allocations to wages versus health care, and the attributes of the health care plan to be offered. Choices include variations in health care plans that require more employee cost sharing, different types of costs (e.g., deductible vs. coinsurance), and the manner in which these costs are distributed (e.g., flat dollar amount toward premium costs vs. percent of wages). Students then make a recommendation, including determining the actual costs of their plan.

Students are divided into groups of 3 - 4 as directed by the instructor. There are several further options when instructing the groups. Demographics of the class may prompt the choice of options.

Option 1: Provide no further instructions beyond what is given on the exercise handout.

Option 2: Because students often base their decisions on their own demographic category (e.g., young, single, healthy), an alternative is to assign to each group a different employee perspective from which to view the health care choices. Groups may be assigned single or multiple characteristics: low versus high income, healthy versus having health conditions, or single versus family. If there are sufficient groups, multiple groups of the same type can be used to capture differences in strategy.

Option 3: Create diverse groups, with individual students within each group assigned to a particular employee demographic profile (income, health, single/family plan). Graduate students or demographically diverse classes may benefit from this option.

Groups should be given about 30 minutes to develop their recommendation. (Groups may also be assigned to work on this step outside of class time). The instructor may find it useful to circulate the room and responds to questions. Questions often involve how to figure out costs and working with average employee wage. When the groups are finished, they record their plan, including cost sharing, on the board for everyone to see. Groups that finish early can begin to discuss the questions found at the end of the exercise handout. Groups take turns explaining the logic of their choices to the rest of the class. Finally, the instructor should guide a discussion of the class as a whole, making sure key issues, as indicated in the discussion questions, are addressed. The discussion period takes 30-40 minutes depending on the variety of solutions that the students propose and the depth of analysis of the discussion questions.

The discussion questions include:

- How do health, age, income, and family status of employees affect their preferences in distribution of total compensation?
- Employer-provided health care is not currently subject to income tax. How might this affect employee preferences? How might employee preferences change if benefits were paid from after-tax income?
- How would you go about designing a plan that is fair to everyone?
- How much of a pay increase is necessary to motivate and retain workers?
- What should Jim and Jane do if health care costs increase another 25% next year and they are confronted with the same dilemma?
- Did the rate of inflation have any impact on your decision?

STUDENT SOLUTIONS AND DISCUSSION

Whole-class discussion involves assessing the advantages and disadvantages of each plan as a whole and for various demographic groups. Dividing students into groups according to Option 2 promotes the most varied solutions. Although some groups choose to remain with the current health plan, other groups propose very creative solutions. Groups choosing to remain with the current health plan provide a good opportunity to discuss potential decision making traps such as the status quo bias (Samuelson & Deckhouse, 1988). It is also a good opportunity to point out that this choice, while not requiring employees to share premium costs, results in average wage increases that do not address the impact of inflation.

At some point in the discussion, a second handout (Appendix B) can be distributed by the instructor to summarize the plan costs and issues. As the discussion proceeds, certain valuable points can be brought out either by the students or the instructor. First, there is no single correct answer. Although the scenario is based on a real organization, the key is for students to understand the impact of their solutions. Second, these solutions do not encompass all options that the firm should pursue, particularly in the long term. As a company of only fifty employees, the owners could look for a way to join with other business owners for health care coverage. A wellness program may result in reduced premium costs and healthier employees. In addition, the employer can provide greater education about FSAs and the impact of health care benefits on taxes. Finally, students can be reminded that this exercise focuses on the overall wage and benefit structure. Although average wage increases are calculated, the dollar amount of those increases varies according to the employees' actual wages. A merit compensation system may also be in place such that the wage increases in the exercise are average percent increases and the actual percent increase could vary by employee.

CONCLUSION

Time constraints and other limitations often work against efforts to integrate the contents of textbook chapters. Nevertheless, it is important to help students make connections between topics, such as the elements that comprise total compensation. This exercise is one way to connect the context of what, in my course, spans three different chapters. In addition, the placement of the unit on benefits in my course occurs before we discuss labor relations. As a result, when we reach that topic, the importance of health care benefits as a subject for negotiation of a collective bargaining agreement can be emphasized. The exercise also helps students view the issue of health care benefits from both the perspective of the employer and the employee. The active learning approach allows students to be actively involved in applying course concepts to a realistic situation.

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APPENDIX A

Total Compensation: Difficult Choices

Jim and Jane's Quality Widgets is in a tough spot. Although they have had a profitable year, the rising cost of health care has put a crimp in their budget. For as long as they have been in business, they have paid 100% of medical insurance premiums for their employees and the employee's family. Until recently, employees also paid no deductible or coinsurance. This coverage is generous compared to other employers in the labor market, and Jim and Jane suspect that many of their employees do not realize this. Thus, employees will be shocked if cost increases force the company to require them to pay for part of the cost of premiums. Jim and Jane also realize that, especially for the lower skilled workers with lower wages, paying for even some of medical premiums will hit them hard. On the other hand, they also want to give their employees a pay increase. This desire stems from many factors, including the need to remain competitive in the labor market, respond to inflation, and reward employees for their performance over the past year.

Jim and Jane have decided to solicit input from representatives of different employee groups. They want to get opinions, and they also realize that any decision will be more acceptable to employees if they have been involved in making the decision. You are one of the employee representatives and have been provided with the information below. **Your task is to propose a compensation and benefits plan for the next fiscal year within the budgeting constraints that face Jim and Jane's Quality Widgets.** Your insurance company has provided cost estimates for various plans. These options can be your starting point, but you may be as creative as you wish in distributing those costs, keeping within your budget.

Current medical plan: PPO (Plan A):

Premium cost: 3000 single employee; $6000 family
Co-pay: $15 per doctor visit
Deductible: $200 individual/$400 family per calendar year
Coinsurance: Insurance covers 100% of costs after co-pay and deductible

Next plan year: *(25% increase for family plan!!)*

Plan A Premium cost: $3500 single employee; $7500 family (same as current plan)

Plan B Premium cost: $3150 single employee; $6750 family
Co-pay: $15 per doctor visit
Deductible: $500 individual/$1000 family
Coinsurance: 10% employee/90% insurer (up to $1000 person/$2000 family)

Plan C Premium cost: $3000 single employee; $6000 family
Co-pay: $20 per doctor visit
Deductible: $750 individual/$1500 family
Coinsurance: 20% employee/80% insurer (up to $1000 person/$2000 family)

Other information: The inflation rate is 3%. Current wage cost: $2.3 million; 50 employees. Assume that 80% of your employees require family medical benefits and that you have a mix of incomes, ages, and levels of healthiness. Total budget amount available to pay for benefit costs increases and/or wage increases next year: $70,000.

There are several options to decrease employer health care costs and/or shift balance of wages and benefits in total compensation. (You should first compute the total cost <u>increase</u> for each option over the previous year).

*Decrease premium cost by increasing deductible/coinsurance as in Plan B and C
*Institute cost sharing of premium by employee (e.g., employee pays 10%, 20%, etc. of single employee and/or single employee premium)
*Wage increase vs. health care: company could continue to pay total cost of premium but provide a lower wage increase.
[Remember that benefits are not taxed; neither are contributions to FSAs.]

<u>If you choose to have employees share cost of premiums:</u> Would you have every employee pay a flat rate (e.g., every employee pays $50/mo., $100/mo for family rate) or as a percent of income (e.g., employees pay 2%, 5% of wages)?

How would age, health, income, or family status of employees affect their preferences?

Discussion Questions:

- How do health, age, income, and family status of employees affect their preferences in distribution of total compensation?

- Employer-provided health care is not currently subject to income tax. How might this affect employee preferences? How might employee preferences change if health care costs were paid in after-tax dollars?

- How would you go about designing a plan that is fair to everyone?

- How much of a pay increase is necessary to motivate and retain workers?

- What should Jim and Jane do if health care costs increase another 25% next year and they are confronted with the same dilemma?

- Did the rate of inflation have any impact on your decision?

APPENDIX B

Total Compensation: Choices and Issues

Same plan (A) total cost increase:
[(7500 - 6000) x 50 x .80] + [(3500 - 3000) x 50 x .20] = 60,000 + 5000 = 65,000
Plan B total cost increase:
[(6750 - 6000) x 50 x .80] + [(3150 - 3000) x 50 x .20] = 30,000 + 1500 = 31,500
Plan C total cost increase: none

Average annual employee pay = $2.3 million / 50 = $46,000

<table>
<tr><td>Plan B
No cost share
Cost to company $31,500

$70,000 - $31,500 =
$38,500 remaining for wage increases
$38,500/2.3million =
1.67% ($770) average pay increase
Issues:
-Family with highest medical expenses will spend $1600 more than current plan</td><td>Plan C
$70,000 for raises
3.04% ($1400) average pay increase

Issues:
Healthy/moderate people could pay for all of their medical expenses</td></tr>
<tr><td>Same plan (A) but with 10% cost sharing
Employee pays $750/350 of premium
Total employee share = $33,500
[($750 x 50 x .80) + ($350 x 50 x .2)] = $33,500

Employer cost: $65,000 - 33,500 = $31,500

$31,500/$2.3 million =
1.37% ($630) average pay increase
Issues:
-Average pay increase is less than cost share of premium
-Cost of premiums charge as flat rate or as percent of pay?</td><td></td></tr>
</table>

Factors:
Income level - Should lower-level employees pay the same amount toward their premiums as higher paid employees? Will pay increases cover the cost of premiums?
Age/Health - Healthy employees prefer low premium, high deductible
Single/Family - Should the company pay the entire premium for everyone? Just the employee?