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## A Theoretical Exploration of Firms' Decisions About Flexible Benefits Plans

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### Abstract

The purpose of this paper is to examine the implications of current theories for organizations' decisions about employee benefits, an area that has traditionally received little attention from researchers in the field of human resource management. Drawing on organizational and economic theories, we offer alternative explanations for observed patterns in the adoption and design of flexible benefits plans. By critically analyzing current theories in the context of flexible benefits plans, we hope to gain insights not only into the factors that may determine organizations' benefits decisions, but also into the strengths and weaknesses of the theories themselves. We find that the conflicts, overlaps and limitations inherent in the theories as applied to benefits issues are substantial. The implications for future research are discussed.

### Keywords

firm, flexible, benefit, plan, decision, employee, organization, human, resource, manage, research

### Comments

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FIRMS' DECISIONS  
ABOUT FLEXIBLE  
BENEFITS PLANS

Working Paper 92-17

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A THEORETICAL EXPLORATION OF FIRMS' DECISIONS  
ABOUT FLEXIBLE BENEFITS PLANS

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This paper has not undergone formal review or approval of the faculty of the ILR School. It is intended to make results of Center research, conferences, and projects available to others interested in human resource management in preliminary form to encourage discussion and suggestions.

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ABOUT FLEXIBLE BENEFITS PLANS

ABSTRACT

The purpose of this paper is to examine the implications of current theories for organizations' decisions about employee benefits, an area that has traditionally received little attention from researchers in the field of human resource management. Drawing on organizational and economic theories, we offer alternative explanations for observed patterns in the adoption and design of flexible benefits plans. By critically analyzing current theories in the context of flexible benefits plans, we hope to gain insights not only into the factors that may determine organizations' benefits decisions, but also into the strengths and weaknesses of the theories themselves. We find that the conflicts, overlaps and limitations inherent in the theories as applied to benefits issues are substantial. The implications for future research are discussed.

This paper examines how current organization and economic theories explain observed variation in the adoption and design of an innovative employee benefits practice. Specifically, we will offer alternative theoretical explanations of firms' decisions about flexible benefits plans, an increasingly popular type of plan that has been the subject of much debate and interest over the past decade (Meisenheimer and Wiatrowski, 1989). The focus is twofold: first, to develop theoretical explanations of observed patterns in the incidence and design of flex plans; and second, to critically analyze the potential power of existing behavioral theories to explain or inform firms' decisions about employee benefits. We draw on economic and organizational theories to identify some of the factors that may be influencing decisions about whether or not to implement flex plans, and how to structure them. Further, we evaluate the extent to which each of the theories can be used to explain decisions about flex. Finally, we compare and contrast the implications of all of the theories and suggest an agenda for future research.

## FLEXIBLE BENEFITS PLANS

The introduction of flexibility into employee benefits by a handful of American firms in the 1970s represented a substantial departure from traditional practice. Whereas managers of traditional benefits plans made decisions about the type and level of benefits employees would receive, employees participating in flexible benefits plans were now allowed to make many of these decisions themselves. The incidence of these innovative plans among American firms was initially quite low, in part because legislation governing the taxation of benefits offered under a flexible arrangement was ambiguous, and it was not until the mid 1980s that they began to gain popularity.<sup>1</sup> Flex was only offered by 17 major U.S. employers in 1981, and only 99 in

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<sup>1</sup> The doctrine of "constructive receipt," in effect until 1978, required that employees who could opt to receive cash in lieu of nontaxable benefits be held liable for taxes on the value of the cash option, regardless of whether or not they actually received it. The Revenue Act of 1978 overruled the doctrine of constructive receipt for cafeteria plans

1983, but by 1992 over 1,400 plans had been implemented (Hewitt, 1992). Survey evidence suggests that the incidence is highest in the service industry: 63% of the top 100 commercial banks, 46% of the top 50 diversified financial firms and 46% of the top 50 utilities currently offer flex (Hewitt, 1992). There is also evidence of considerable variation in the design of flex plans. Plans that simply give employees the opportunity to contribute pre-tax income to a reimbursement account (called a flexible spending account) for uncovered medical expenses, as well as those that allow employees to select from among multiple types and levels of benefits, are all considered to be flexible benefits plans.

The merits of flexible benefits plans were espoused over twenty years ago by Lawler (1971), who argued that allowing employees to fashion their own compensation packages heightens their awareness of benefits costs and ensures that they receive the benefits that they want. In this way, he wrote, flex plans increase the perceived value of employees' pay, and hence pay satisfaction. From an expectancy theory perspective, flex plans should therefore reduce turnover and enhance attraction, since they increase the perceived value to employees of working for the organization. This rationale has become even more compelling in recent years. Lawler (1981: 76) points out that the workforce has been changing in a number of ways (e.g., increasing heterogeneity, less acceptance of traditional authority, changing family structures) that make flex plans attractive to a substantial portion of employees, and suggests that "flexible benefits would seem to be potentially effective in most organizations."

Benefits satisfaction is not the only justification for adopting flexible benefits plans. Advocates have also argued, for example, that these plans can help firms increase employee understanding of benefits and unify benefit programs (Frieden, 1989; EBRI, 1991; Hewitt Associates, 1991). More frequently mentioned is the argument that these plans can help firms contain health care costs (see, e.g., Frieden, 1989; EBRI, 1991; A. Foster Higgins, 1991;

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that are nondiscriminatory, but offered no guidelines for determining whether plans are in compliance with the law. Guidelines which clarified these and other legal uncertainties were issued by the Internal Revenue Service in 1984, and incorporated that year into the Deficit Reduction Act (Bloom and Trahan, 1978; EBRI, 1991).

Hewitt Associates, 1991). Theoretically, cost containment is achieved by moving firms from a defined benefit (in which a certain level of coverage is promised, regardless of cost) to a defined contribution (in which a certain level of benefits expenditures is promised, regardless of the level of coverage the funds can purchase) arrangement. Further, advocates believe that the prices of options can be so structured as to encourage employees to move into more cost-effective health care plans.

It is not clear that employers have relied on the reasoning of Lawler (1971, 1981), or others who have written on the subject, when making decisions about flexible benefits plans. If carried to its logical conclusion, Lawler's pay satisfaction argument implies that any firms whose production costs are tied to their capacity to attract and retain qualified employees would have a strong reason to implement flex. Furthermore, the workforce in most firms is becoming increasingly diverse, and the premiums for traditional group health insurance plans are escalating at a rate of 20%-25% per year (Woolsey, 1991). Yet twenty years after Lawler first made his argument, only 25%-30% of American firms now offer flex plans (EBRI, 1991; Kitts, 1991).

The high costs of program design and implementation, paternalistic concerns about employees' capacity to make sound decisions, and actuarial concerns about disproportionate participation rates across options have been offered as reasons that many organizations have not implemented flex plans (Bloom and Trahan, 1986). Since some firms are deterred by these potential problems and others are not there must be other factors, factors specific to the organization, driving the decision to implement flexible benefits plans. Such factors may also influence program design. There is some evidence, for example, that where cost containment is the primary objective, flexible spending accounts are not offered as an option, yet there are still a sizeable number of firms that do not follow this pattern (Hewitt Associates, 1989). Thus, in addition to plan objectives, contingencies unique to the organization may constrain the design of benefits plans.



To identify the factors that can help explain the patterns of decisions organizations have made about flexible benefits plans, we turn to the organizational and economic theories that have implications for the design of employee compensation systems. Many of these theories have been successfully applied in previous studies to explanations of organizations' pay practices, and thus applying them to explanations of the related issue of benefits practices does not seem unreasonable. Eisenhardt (1988), for example, found that both the agency and institutional models did a good job of describing variation in the pay policies (salary versus commission) in effect for salespersons employed at retail stores. Similarly, Pfeffer and Davis-Blake (1987: 452) found that a model derived from the resource dependence perspective accounted for "a substantively important amount of the variation in relative wages" paid to six administrative jobs common to both private and public universities.

In this paper, we explore the implications of current organizational and economic theories for explanations of firms' decisions about flexible benefits plans, and assess where they overlap and/or conflict. Further, we identify what, if any, questions each of the theories does not address, and thus the extent to which multiple perspectives may be required to fully explain the phenomenon. In so doing, we hope to develop a clearer understanding of the insights these theories have to offer into how organizations make decisions about employee benefits, where they fall short and need to be developed, and where empirical investigations may be needed to test the efficacy of conflicting models. Thus, by examining current theories in the context of flexible benefits plans, we gain insights not only into the factors that may determine organizations' benefits decisions, but also into the strengths and weaknesses of the theories themselves.

## FACTORS THAT INFLUENCE THE INCIDENCE AND DESIGN OF FLEXIBLE BENEFITS PLANS: IMPLICATIONS FROM THEORY

### **Institutional Theory**

According to the institutional perspective, an organization's decision about an innovative administrative technology such as flexible benefits is influenced less by "efficiency" considerations than by environmental pressures to conform (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Scott, 1987; Zucker, 1987). Organizations will adopt an innovation, even if it is technically inefficient, in order to gain legitimacy, resources, and/or stability, and hence to ensure their survival (Meyer and Rowan, 1977: 26). By following prevailing practice, an organization may enhance its effectiveness, but not necessarily by improving internal, "technical efficiency," or the "internal process" (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Tolbert and Zucker, 1983). Thus, for example, organizations may be coerced into adopting an innovation by powerful organizations (e.g., governmental bodies or unions) that control resources, they may imitate the practices of other organizations as a means of coping with uncertainty about technologies or goals, or their professional staff may respond to normative pressures to conform to standards of practice established by educational institutions and/or professional networks (DiMaggio and Powell, 1983).

Institutional theory does not imply that an organization's decision to adopt an innovation will always be the result of normative pressures to conform. The perspective distinguishes between early adopters, who introduce an innovation based on its capacity to improve organizational performance, and late adopters, who are more likely to behave according to prevailing practice (DiMaggio and Powell, 1983; Tolbert and Zucker, 1983). Tolbert and Zucker (1983), for example, found that performance-related factors could more effectively explain early than late adoption of civil service systems by cities.

Institutional theory thus implies that early adopters of flexible benefits plans (those that implemented flex in the 1970s and early 1980s) may have had "rational," performance-related reasons for their decisions. As the plans became more popular, their instrumental utility would have become less important than their normative value, and the organizational factors related to their implementation and design would have less to do with the potential for effectiveness than with the organization's susceptibility to social/political influences. The theory is not at all clear, however, about how to delineate where rational, efficient behavior ends and mimicry begins. How do we identify the point where an innovation has become institutionalized and firms' decisions about adopting it cease to be rational? Since 1981, when only 17 major U.S. employers offered a flexible benefits plan, almost 1400 more such plans have been implemented (Hewitt, 1992). Is this an indication that the plans have become legitimized, or is the fact that at least 70% of American firms have not implemented them an indication that this is still the early adoption stage?

For purposes of discussion, we will assume that flexible benefits plans have become legitimated elements of some institutional environments. Further, we will designate 1984 as the probable time when normative pressures would have begun to affect firms' decisions about the plans, since that was the year that the first surge of implementations occurred (Hewitt Associates, 1992).

**Early adoption (1970s and early 1980s).** Organizational conditions in early adopters of flexible benefits plans should, according to the institutional perspective, have been such that the promised outcomes (enhanced benefits/pay satisfaction, cost containment) could be achieved by introducing these plans. It would therefore seem that the earliest adopters of flex would have had employees with a wide range of demographic characteristics, whose needs would be unlikely to be met by a single benefits package. Other workforce characteristics related to employee preferences could also be expected to be related to early, performance-related, decisions about adopting flex. Lawler (1987: 75), for example, has argued that as the workforce has become more educated, its members have become "interested in influencing work

decisions." If this is true, then the demand for increased participation in benefits decisions would likely have been highest in firms with well-educated work forces. In contrast, many unions were initially opposed to flexible benefits plans, perhaps objecting to the move to a defined contribution promise, or the shift away from egalitarian benefits arrangements to more differentiation (Bloom and Trahan, 1986; EBRI, 1991). This suggests that organizations with significant union involvement would have been unlikely to propose such plans.

Organizations that could expect to realize substantial cost savings by implementing flex would also have had performance-related reasons for implementing this type of plan. Firms with generous benefits packages, including first-dollar medical insurance, for example, could theoretically contain the rising costs of benefits by moving to a defined benefit (in which a certain level of benefits is promised regardless of cost to the employer) to a defined contribution (in which a certain dollar contribution toward the purchase of benefits is promised, with no promise of maintaining a certain level) arrangement.

Finally, factors that affected ease of implementation could be expected to influence the firm's decision to adopt flex. Large firms, and/or firms with extensive data processing capabilities, for example, might have the capacity to implement and manage flex plans more efficiently than would smaller firms (Lawler, 1981), particularly in the early years of adoption, when software packages simplifying program administration were not yet available. Thus,

*Proposition 1: Decisions about implementing flexible benefits plans during the early years of adoption will be a function of organizational factors related to the plans' potential effectiveness (diversity and educational level of the workforce, degree of unionization, level of employer-provided benefits, firm size, and data processing capacity).*

*Proposition 2: The explanatory power of performance-related factors will be greater during the early years of adoption (1970s, early 1980s) than during the later years of adoption.*

Factors that potentially affected the design of initial flex programs would also be related to "rational" considerations, according to the institutional perspective. If the design of these and other HR programs is rationally driven by program objectives, then variation in the type of plan can be explained by variation in objectives. Thus, programs implemented primarily to meet the diverse benefits needs of a heterogeneous work force would be expected to offer multiple options, rather than just a stand-alone spending account. In contrast, programs aimed more at cost-containment should tend to have explicit incentives to reduce consumption of health care. These programs might be less likely to offer flexible spending accounts, since, by allowing employees to pay insurance premiums and uncovered medical expenses with pre-tax dollars, these accounts essentially reduce the cost to workers of medical care and hence their incentive to use it carefully. They will also be more likely to use credit-based systems, since the advantages of opting down to insurance plans with higher employee copayment provisions (and having more credits for other benefit options) are more visible (Hewitt, 1989).

*Proposition 3: Among firms that implemented flex plans during the early years of adoption, those that emphasized employee satisfaction as a primary objective will have the widest range of options, all else equal. Those that emphasized cost containment as a primary objective will be the least likely to offer flexible spending accounts and the most likely to use a credit-based system, all else equal.*

*Proposition 4: The strength of the relationships between plan objectives and plan design will be greater during the early than the later years of adoption.*

**Late adoption (mid-1980s to present).** Institutional theory suggests that prevailing normative pressures within a field lead to increasing homogeneity of organizational forms and practices over time (DiMaggio and Powell, 1983; Tolbert and Zucker, 1983). This implies that firms' decisions about flex should be similar within an organizational field. Thus, firms operating in a field in which the incidence of flexible benefits plans is high would be more likely to decide to implement flex than would firms in a field where the incidence is relatively

low. Similarly, decisions about how to design flex plans should be influenced by prevailing practice in the firm's field.

*Proposition 5: The higher the portion of firms in a field offering flex plans, the higher the probability that a new firm entering the field will adopt a benefits plan that is flexible, all else equal.*

*Proposition 6: The higher the portion of firms in a field offering a particular flex plan feature (e.g., flexible spending account), the higher the probability that a new firm entering the field will include this feature into its benefits plan, all else equal.*

In addition to field, other organizational characteristics are needed to explain decisions about innovations, since some organizations are "interpenetrated by the institutional environment, while others are not" (Zucker, 1987: 451). Institutional theorists have proposed a number of conditions which affect an organization's susceptibility to normative pressures to conform. Organizational uncertainty about goals, for example, theoretically causes some organizations to imitate the practices of other organizations that are perceived as successful (DiMaggio and Powell, 1983; Scott, 1987; Zucker, 1987). DiMaggio and Powell (1983) argue that uncertainty about technologies or goals, dependence on other organizations for resources, and/or professionalization of managerial staff reduce an organization's immunity to the influences of their institutional environments. Thus, for example, research and development units, whose technologies change frequently, or firms managed primarily by professionals, who may be heavily influenced by standard-setting academic institutions or professional networks, would be apt to adopt the prevailing human resource practices in their field. Further, organizations that have control over critical resources, such as government funding agencies or unions, can coerce other organizations that need these resources into adopting innovations that the powerful parties have an interest in promoting. Governmental involvement in the promotion of flex plans, however, has not been coercive, but rather has been limited to passing legislation which affects the financial advantages to the firm of offering such

plans. Further, the influence of unions on firms' decisions about flex is unclear, since, in recent years, union power has been diminishing, as has their resistance to flexible benefits plans (Hewitt Associates, 1989; McCaffery, 1992). Thus, in the flexible benefits context, conditions making organizations dependent on coercive agents may not have much explanatory power.

*Proposition 7: Within a field in which the portion of firms offering flexible benefits plans is high, those firms that are most susceptible to normative pressures to conform (because of uncertainty, professionalization) will be the most likely to adopt these plans, all else equal.*

*Proposition 8: Within a field in which the portion of firms offering flexible benefits plans is high, the probability that a firm will offer the flex plan feature(s) most commonly offered by other firms in the field will be positively related to their susceptibility to normative pressures to conform, all else equal.*

Institutional theory seems to imply that firms have been implementing flexible benefits plans in ever increasing numbers in recent years not because the plans will enhance firm performance, or efficiency, but simply because "everyone else is doing it." However, this reasoning seems to be based on a somewhat narrow focus on the efficiency of internal, or technical operations - the performance of "core tasks" (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Zucker, 1987). Zucker (1987: 445), for example, argues that "efficiency and success do not necessarily covary in institutional theory: Organizational conformity to the institutional environment increases positive evaluation, resource flows, and therefore survival chances, *and* reduces efficiency." If, on the other hand, efficiency is more broadly viewed in terms of the level of performance relative to the conditions in both the internal and external environments, then it would seem that increasing resource flows and survival chances would *increase* efficiency.

Firms may have performance-related reasons for following prevailing benefits practice. Many firms, for example, cite "meeting competitive pressures" as a primary objective for their flex plans (Hewitt Associates, 1991). Such firms may be competing in labor markets which are tight and in which flex plans predominate. Offering flex may help them to compete for critical skills. Thus, while it may be true that some of the variation in decisions about flex is a function of normative pressures to conform, some portion of the variation may be due to more "rational" considerations.

The application of institutional theory to explanations of patterns of organizational behavior is also limited because of ambiguities in the definitions of key constructs. For example, the identification of an organization's relevant field, or institutional environment, can be quite difficult. DiMaggio and Powell (1983: 148) define organizational field as "those organizations that, in the aggregate, constitute a recognized area of institutional life: key suppliers, resource and product consumers, regulatory agencies, and other organizations that produce similar services or products." Perhaps due to the ambiguity of such terms as "key," or "similar," DiMaggio and Powell (1983: 148) argue that "the structure of an organizational field cannot be determined a priori but must be defined on the basis of empirical investigation." This suggests that institutional-based investigations of the determinants of flexible benefits plans cannot be carried out until all relevant organizational fields have been empirically delineated. Further, as Zucker (1987) points out, institutional forces can cut across fields, similar organizations can operate in very different fields, and fields can be differentiated by many factors, thus making it difficult to identify the relevant sources of influence on any particular organization.

It may also be difficult to operationalize "normative pressures," since the theory does not specify any indicators of this construct. Assuming that such pressures exist simply because a high percentage of firms in a field have similar structures seems too simplistic, yet the lack of a specific definition of "normative pressures" precludes more precise measurement.



### **Resource Dependence Theory**

Like the institutional perspective, the resource dependence perspective assumes that organizational actions and decisions are constrained by environmental conditions. Here, agents who control critical resources are assumed to exert influence over the organizations that are dependent upon them (Pfeffer and Salancik, 1978). Thus, for example, an organization's decisions about compensating its employees will be constrained to the extent that productivity is dependent upon how they use critical resources (e.g., skills, other employees, capital assets) over which they have control (Bartol and Martin, 1988). Theoretically, firms will attempt to counteract their dependence on these employees by offering compensation packages which are high relative to their qualifications, thus making them dependent on the organization and increasing their motivation to use resources carefully.

The theory thus implies that firms with a high degree of resource dependency on their employees will be motivated to increase the value of their compensation packages relative to that offered by their competitors in the labor market. It has implications about the relative *level* of compensation, but the implications about the *form* is less clear. It seems unlikely that all employees would view the introduction of flexible benefits plans as a gain. Enrollment procedures can be confusing and time-consuming. Further, there is some evidence that acceptance of human resource innovations such as flex decreases with tenure (Kossek, 1989). Firms where the average tenure of employees is relatively high, therefore, might actually lower the perceived value of compensation packages by introducing flex. Resource dependence theory can therefore suggest the types of organizations that will be motivated to increase the value of their compensation packages, but not the types that are likely to accomplish this by implementing flex. Moreover, flex plans can theoretically achieve firm objectives other than increasing employee satisfaction with compensation. For example, by moving firms from the promise of a defined benefit to a defined contribution, and/or encouraging employees to enroll in more cost effective health plans, flexible benefits packages can generate considerable cost savings. Resource dependence theory offers no insights that could help identify those firms that

would be likely to implement flex plans for reasons other than increasing the value of employee compensation.

Resource dependence theory does, however, have implications for the design of flex plans. The theory suggests that firms with high levels of dependence on employee resources will want to increase the perceived value of the compensation package. If these firms decide to implement a flexible benefits plan, they are therefore likely to emphasize employee benefits satisfaction more than efficiency objectives such as cost containment. Since they are seeking to satisfy the benefits preferences of all of their employees, these firms might want to implement so-called "full flex" programs, in which employees are given a choice among several types and levels of benefits. Flexible spending accounts should also be incorporated into these plans, since they provide employees with the valuable opportunity to spend pre-tax dollars on uncovered medical and child care expenses.

The theory also suggests that firms with relatively low levels of dependence on employees are less likely to be concerned with raising the value of their compensation packages relative to their competitors in the labor market. If these firms implement flexible benefits plans, then, plan design would more likely be driven by efficiency motives such as cost containment. The plans would be less likely to include flexible spending accounts, which theoretically provide incentives to increase medical care consumption (since they effectively lower the price of medical care), or a wide range of options that would be costly to manage.

Factors that are related to resource dependency on employees include task uncertainty, task centrality, ease of observing and monitoring productivity, ease of replacing workers, and the extent to which specialized skills are required to achieve important tasks (Bartol and Martin, 1988). Firms in which the production technology is routine and requires unskilled labor inputs would experience less dependency on their employees than firms with significant research and development components, which depends on less readily observable and controllable creative skills related to product development. Additionally, it may be more difficult, and/or more costly, to monitor employee performance in large than in small firms.

*Proposition 9: Among firms with flexible benefits plans, those that can be characterized as having a high degree of dependence on employee resources, for example large firms and/or firms with significant research and development components, will be more likely to offer flexible spending accounts and a full menu of options than will firms where the degree of resource dependence is low, for example small firms, all else equal.*

Organizations are not only dependent on the resources controlled by employees, but also on those controlled by other organizations. Thus, the resource dependence perspective also implies that organizations' actions may be subject to the influence of organizations that control the flow of external resources (Pfeffer and Salancik, 1978). Government agencies, for example, can impose restrictions on the compensation systems of organizations that have federal contracts. Organizational dependence on external resources can only explain decisions about a particular structure, however, if the organizations controlling these resources have an interest in promoting it. Currently, government funding is not tied to organizations' decisions about flexible benefits plans. Unions may control the supply of labor to some organizations, but since their power has been diminishing and their reaction to flex plans has been mixed, their explanatory power in this case is questionable. Thus, the resource dependence perspective can relate organizations' dependence on employee resources to their decisions about the design of flexible benefits plans, but it cannot explain their decisions about the adoptions of these plans, nor can it relate dependence on external resources to any of these decisions.

### **Population Ecology**

Organizational survival, rather than adaptation, is the focus of the population ecology perspective (Hannan and Freeman, 1977). As with the institutional and resource dependence theories, this perspective assumes that organizational structures are related to conditions in the environment. In contrast to other models, however, population ecology does not assume that organizations adapt their structures to environmental conditions, but rather that environmental

conditions determine which organizations will survive. Strong inertial pressures theoretically prevent organizations from adapting their structures to changing conditions, and when the environment changes only those organizations whose structures are optimal in that environment will survive. Organizations with nonoptimal forms do not adapt to the environment and are selected out.

The implication of this theory is that human resource practices that have developed in response to changing conditions will only be found among newly formed organizations, since established organizations will not change. Thus, older organizations would not be expected to implement flexible benefits plans in response to changes in the demographic makeup of the workforce and the ever-rising costs of providing health insurance to employees. Rather, such plans should only be found among organizations that have been established since the early 1970s, when the concept was first introduced and firms were beginning to confront issues related to a diverse workforce and escalating health care costs. Since this is clearly not the case, it would seem that the population ecology approach provides little help in explaining organizations' decisions about flexible benefits plans.

### **Agency Theory**

The agency model of employment contracts is based on the premise that the interests of owners, or principles, will not always be the same as those of the agents, or employees, and that compensation packages should be designed to motivate employees to act in the best interests of the principal (Ross, 1973; Jensen and Meckling, 1976). Designing efficient contracts can be difficult, however, because of inherent trade-offs between the provision of incentives and the efficient allocation of risk. By paying workers for their output, employers provide a powerful incentive to produce as much of the desired output as they can. But other, "exogenous," factors besides employee effort can influence the amount and value of output. Thus, output-based pay schemes expose the employee to these exogenous risk factors over which they have no control. Workers are assumed to be risk-averse, preferring certain income to uncertain income of

higher expected value; they are willing to "pay" for certainty by accepting lower wages. Employers, on the other hand, are assumed to be risk neutral, since they are in a better position, having more assets, to bear the risks of such exogenous factors as unstable product demand. Moreover, employers' labor costs will be lower when they bear these risks since they will not have to compensate workers for the disutility of having uncertain income. A pay scheme that bases compensation on output will therefore provide workers with a powerful incentive to act in the best interests of the principal, but it will also result in an inefficient allocation of risk. Risk-averse workers, and risk-neutral employers, can both be made better off by shifting the risks to the employer.

Shifting all of the risks to the employer, however, is not optimal in many situations due to asymmetry of information. Without incentives, employees have no reason to act in the best interests of the employer. The problem does not occur when employers have perfect information about employee effort, since they can easily identify and sanction inappropriate effort levels. Obtaining information about employee effort is not always possible, and in this situation employers must introduce incentives for workers to optimize their effort.

Designing the optimal, or efficient, employment contract, thus requires "finding the appropriate reward formula that generates incentives for the supply of the desired inputs at the least cost in terms of inefficient risk sharing" (Nalbantian, 1987: 12). It is this consideration, according to some theorists, that lead employers to pay "efficiency wages," that is wages that are above the market-clearing rate (Nalbantian, 1987; Stiglitz, 1987). By paying these high wages, employers create an incentive for employees not to shirk, since, if they were caught shirking, they could lose their job and the high wages. Under an efficient wage contract, employees do not bear the risk of exogenous factors, yet they have an incentive to work hard enough to keep their jobs.

Employers are more likely to offer efficient wages in situations where information about employee effort is difficult to obtain. Thus, task uncertainty, ease of monitoring productivity, and firm size will all affect the employer's motivation to increase the value of the compensation

package. Small firms, and/or firms characterized by routine, assembly-line type technologies are therefore less likely to experience principal-agent problems than are large firms, and/or firms with significant research and development components, where task achievement is more difficult to monitor and control.

The implications of this theory for the incidence of flexible benefits plans are quite similar to those drawn from a resource dependence perspective. Under both scenarios, employers are induced to offer compensation packages of higher value relative to the market in order to motivate their employees to act on their behalf. As with the resource dependence theory, however, the agency model may be better at explaining decisions about the *level* of compensation than it is at explaining decisions about *form*. This is because offering flexible benefits plans does not in all cases represent an increase in the value of the compensation package, and because the plans are often implemented for reasons other than increasing employee satisfaction with compensation.

The agency model may be more helpful in explaining decisions about the design of flexible benefits plans. Flex plans that emphasize employee benefits satisfaction as a primary objective should be more prevalent among organizations or industries in which information about employee effort is relatively difficult to obtain. These might include large firms, and/or firms who rely heavily on tasks that are difficult to monitor (e.g., firms with large research and development components, service sector firms in which a substantial component of job tasks involves customer relations). Such firms would be more likely, for the reasons discussed above (under "Resource Dependence Theory") to offer "full flex" plans and flexible spending accounts. Where work effort is relatively easy to monitor, the primary flex plan objective is more likely to be cost containment. These plans would not be likely to include flexible spending accounts, or a wide range of options that are costly to administer.

*Proposition 10: Among firms with flexible benefits plans, those in which information about employee effort is relatively difficult to obtain will be more likely to offer*

*flexible spending accounts and a full menu of options than will other types of firms, all else equal.*

### **The Transaction Cost Approach**

An economic approach to the study of organizations, this perspective assumes that decisions about structures are based primarily on efficiency considerations, and that efficiency is evaluated in terms of transaction costs (Williamson, 1981). Thus, organizations' decisions about structures for managing the employment relationship will be based on the characteristics of their human resource transactions that affect efficient operations. On this issue, Williamson (1981: 564) argues that the salient characteristics of an organization's "human assets" are: "(1) the degree to which they are firm-specific, and (2) the ease with which productivity can be metered." Where individuals' productivity levels are difficult to monitor, efficient governance structures would enhance employee motivation. Further, where critical skills specific to the firm are acquired primarily on the job, employers have a vested interest in protecting the employment relationship, since such skills are not easily replaced. In such firms, internal governance structures will be efficient if they stabilize employment. Benefits that accrue with seniority, for example, would discourage quitting (Williamson, 1981). Alternatively, compensation packages that exceed what employees could obtain elsewhere would also discourage quitting.

The transaction cost approach thus implies that firms' decisions about the structure of employee compensation will be a function of the skill-specificity of labor and the ease of monitoring productivity. Ease of monitoring is also an explanatory factor under the resource dependence and agency models, as is the extent to which organizations need to motivate important employee behaviors. Thus, all three perspectives imply that organizational dependence on the behavior of certain employees whose interests may not coincide with those of the firm, as well as difficulties monitoring productivity, will cause organizations to offer above-market compensation packages as a means of motivating work effort. As argued above, these

perspectives have implications for the level of employee compensation, but not the form, and therefore cannot help explain firms' decisions about the adoption of flexible benefits plans. Among those firms that have implemented flex plans, however, the perspective may be more helpful in explaining plan design.

Since organizations' decisions about structures is assumed to be driven by efficiency considerations under the transaction cost approach, it follows that the design of flexible benefits plans will be goal-related. Organizations that rely heavily on skills acquired on the job tend to establish structures that protect the continuity of employment, according to this perspective, and it is therefore likely that compensation/benefits satisfaction would be a human resource goal at these firms. If, as we have argued above, flexible benefits plans that offer a wide range of options are most likely to meet the benefits needs of all employees, then when such organizations implement flex plans they are likely to include a full menu of benefits. More so than the resource dependence and agency models, however, the transaction cost perspective implies some upper bounds on this trend. The focus is on economizing, and if administrative costs increase with the number of options, then a threshold may be reached beyond which the costs outweigh the returns. In general, however, organizations that rely on firm-specific skills should tend to offer a wider range of benefits options than those that rely on general skills. Where human assets are nonspecific, organizations should tend to be less concerned about maintaining the employment relationship and will be more likely to implement flex plans for cost containment purposes.

*Proposition 11: Among firms with flexible benefits plans, those that rely heavily on skills acquired on the job will be more likely to offer a full menu of options and flexible spending accounts than will firms that rely on nonspecific skills, all else equal.*

The explanatory power of this model depends on the extent to which firms' human assets can be identified as either firm-specific or general. It seems likely, however, that a good number of firms will have a mixture of both. Custodial staff, typists, freight loaders and the like, who do not require firm-specific training, may work in the same firm with accountants,



managers, and executives, who cannot perform their jobs effectively without specific knowledge of organizational operations. Thus, it may be difficult to classify firms into distinct categories that can be used to explain variation in their decisions about compensation structures. The theory would perhaps have more explanatory power if other factors that could potentially affect the costs of human asset transactions were considered. The resource dependence perspective suggests, for example, that the ease with which certain employees can be replaced affects the costs to the organization of losing them.

## RESEARCH IMPLICATIONS AND CONCLUSIONS

Explanations of organizations' decisions about flexible benefits plans can be derived from a number of different organizational and economic theories. As Table 1 illustrates, there is considerable overlap and conflict among the theories covered in this paper. The implications of the resource dependence, agency and transaction cost models are quite similar. All suggest that organizational performance can depend on motivating important employee behaviors, and, while they are not in complete agreement on the indicators of the extent of this constraint, all suggest that the ease of monitoring work effort is important. On the other hand, the various theories disagree on the extent to which organizations' decisions are influenced by external versus internal conditions. The institutional and population ecology perspectives both suggest that structures are determined by forces in the organization's environment. In contrast, the resource dependence, agency and transaction cost perspectives all assume that internal conditions affecting contingencies in employment relationships determine how an organization will structure its compensation package. The resource dependence perspective also considers the influence of external forces, since an organization may depend on resources controlled by other organizations.

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Insert Table 1 about here  
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Assumptions about the determinants of organizations' decisions about practices such as flexible benefits vary widely across models. There seem to be two conflicting themes: decisions about the adoption and design of an innovation are rationally related to the requirements of the work environment; or organizations base their decisions on what others are doing, regardless of the effects on firm performance. Consistent with the first theme, the resource dependence, agency and transaction cost perspectives all imply that organizations can improve productivity by adopting practices that will motivate employees' work and attendance behaviors.

Explanations of firms' decisions about flexible benefits plans thus require an examination of the factors related to the extent of organizational reliance on, and control or influence over, these important behaviors. In contrast, the institutional perspective implies that organizations are less concerned with improving technical efficiency than with reaching an accommodation with their environments. This theory suggests that an organization's "field," as well as factors related to pressures to conform and organizations' immunities to these pressures, can help explain decisions about flexible benefits plans.

None of the theories seem to offer a complete explanation of firms' decisions about flexible benefits plans. The population ecology approach implies that flexible benefits plans will only be observed in recently established firms, and thus cannot help explain why older firms (e.g., TRW, Educational Testing Service) have implemented them. The institutional model does not consider "late adoption" decisions that may be related to "rational" considerations. Further, application of this model may be difficult because an organization's "field" is not easily identified, and because the criteria are unclear for determining when institutional forces begin to exert more influence than rational, performance-related considerations. The resource dependence, agency, and transaction cost perspectives seem to be more helpful in explaining the design than the incidence of flex plans, and each seems to focus narrowly on a single aspect of the

employment relationship. Thus, for example, the transaction cost perspective focuses on the firm-specificity of work skills and the ease of monitoring productive effort, and does not consider other factors (e.g., task uncertainty, task centrality) that would also make high turnover and low work motivation costly. If expanded, however, the transaction cost approach might prove to be the most parsimonious of all the models, since it recognizes not only the importance of efficiency as an important guiding force, but also the impact of environmental constraints beyond the organization's control. It could therefore incorporate the constraints imposed by institutional environments, as well as those imposed by contingencies in employment relationships that are implied by the resource dependence and agency models .

The conflicts, overlaps and limitations inherent in current organizational and economic theories as applied to benefits issues are substantial. The need for further research is clear. A single, comprehensive model can perhaps be constructed from the theories that fall short of complete explanations, or that overlap with other theories. Empirical tests of this and competing models will provide information about their relative capacity to explain benefits decisions. By conducting such research in the context of flexible benefits plans, knowledge is also gained about a proliferating, but inadequately studied, human resource practice.

It should be noted that many of the explanatory variables implied by the theories discussed in this paper may be endogenous in models of organizational structures, and that caution is therefore required when estimating these models. The institutional model, for example, implies that workforce diversity is a determinant of decisions to implement flex plans during the 1970s and early 1980s. However, it may also be true that the presence of flex plans is a causal factor influencing the diversity of the workers who seek employment at an organization. During the late stage of adoption, normative pressures theoretically influence organizations' decisions about flex. Organizations' decisions to adopt flex plans will in turn influence the level of normative pressures in a field. Similarly, the resource dependence, agency and transaction cost models all suggest that inadequate information about work effort will cause organizations to increase the value of their compensation packages. Above-market

compensation packages will theoretically motivate employees to work hard enough to avoid losing their jobs. At the same time, the level of overall compensation may influence employees' willingness to share information about their work effort. Thus, decisions about flex plans are influenced by the extent of information asymmetry, which is in turn influenced by the presence of flex plans. Empirically sound tests of these models may therefore require the estimation of simultaneous equations.

Flexible benefits plans provide a good context for testing the explanatory power of the theories discussed in this paper. Hypotheses about the determinants of these plans can be derived, but not necessarily distinguished, from all of the perspectives. Further, as the diversity of the workforce and the costs of providing health insurance have increased, interest in flexible benefits plans has increased considerably, and it therefore seems likely that decisions about flex have been made by a substantial portion of American firms (Meisenheimer and Wiatrowski, 1989). Finally, the fact that there are currently more than 1400 flex plans being offered suggests that there will be enough data and variance to accurately assess the independent influence of each of the factors that may affect organizations' decisions about them.

There are nevertheless some potential barriers to studying the determinants of flexible benefits plans. First, the data requirements will be extensive, since numerous variables are implied by the theories and a large sample size may be required to obtain the variance necessary for efficient model estimation. Moreover, tests of hypotheses regarding organizations' decisions to implement a flex plan will require data from both adopters and non-adopters. Secondly, obtaining this data may prove difficult, since some of it may be considered proprietary, and not all of it will be documented in existing information systems. For instance, estimation of an explanatory model derived from institutional theory requires information about the level of employer benefits expenditures prior to the implementation of flex. Many firms are justifiably reluctant to release this type of sensitive data. Similarly, the institutional model implies that levels of workforce education and diversity will help explain early but not late adoption of flex

plans, yet it seems unlikely that firms maintain records of the demographic characteristics of their employees over a period of several years.

There are a number of potential sources for the data needed to study flexible benefits plans. The primary source of information, of course, is the organizations that are making the decisions being examined. Alternatively, federal agencies, such as the Bureau of Labor Statistics and the Pension and Welfare Benefit Administration, maintain data on organizations' benefits practices. Surveys are also conducted by consulting firms, who in addition may have consolidated data bases covering their benefits consulting clients. While we recognize that much of this information is privileged and proprietary, and that these organizations may therefore be reluctant to release it, there is ample reason to believe that the economic and demographic conditions in recent years have generated considerable interest in developing knowledge of benefits practices such as flex plans.

Employee benefits have been inadequately researched in the field of human resource management, and there are clearly other phenomena besides flex plans that merit attention. The theories discussed in this paper can also be applied to other innovations in benefits practice, for example managed care, dependent care, employee assistance programs, etc. Organizations' decisions about the level of benefits to provide their employees may also be explained using these theories. The resource dependence, agency, and transaction cost perspectives, for example, all have implications for decisions about levels of compensation. The need for research on these and other benefits issues is substantial.

We have demonstrated that organizational and economic theories have implications for benefits design issues. It is not yet clear how well these theories can actually help explain or inform organizations' decisions about benefits. We suggest that their capacity to explain these decisions can be empirically tested in the context of flexible benefits plans. Results of these investigations may help move toward the development of a multi-theory of benefits, or perhaps existing theory can be adapted to explain this phenomenon.

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Table 1  
 Implications of Organizational and Economic Theories  
 for Decisions about Flexible Benefits Plans

<u>Theory</u>	<u>Key Ideas</u>	<u>Major Predictions</u>
Institutional	Organizational structures are determined by institutional environments. Early adoption of an innovation is performance-related. Later adoption is related to prevailing practice in the field.	Early adoption/design of flex will be a function of factors associated with their potential effectiveness. Later adoption/design will be a function of organizational field and immunity to institutional pressures.
Resource Dependence	Organizational structures reflect efforts to manage relationships with agents that have discretionary control over critical resources.	Predicts design but not incidence of flex plans. Firms with a high degree of dependence on resources controlled by employees will tend to include a wide range of options in their flex plans.
Population Ecology	Inertial pressures prevent organizations from changing structures. When environmental conditions change, only those firms with structures that are optimally adopted to the environment will survive.	Flexible benefits plans will only be observed in firms that have been established since the early 1970s.
Agency	Efficient employment contracts allocate more risk to the employer than to the employee, and also provide incentives for employees to act on behalf of the employer. By compensating employees at above market levels, employers bear the risks of product market fluctuations and motivate employees to work hard enough to keep their jobs.	Predicts design but not incidence of flex plans. Firms in which the majority of the positions fall at the low end of the pay scale and/or employee effort is relatively difficult to monitor will tend to include a wide range of options in their flex plans.

-continued-

Table 1 (cont'd)

Theory	Key Ideas	Major Predictions
Transaction Cost	<p>Organizations develop structures such that the costs of managing key transactions are minimized.</p> <p>The efficiency of alternative structures for managing human asset transactions depends on the degree to which critical skills are firm-specific and the ease with which productivity can be monitored.</p>	<p>Predicts design but not incidence of flex plans.</p> <p>Firms that rely heavily on skills acquired on the job will tend to include a wide range of options in their flex plans.</p>