Methods of Earning Pay

Pay is compensation an employee receives for work performed for an employer. There is not one standard method of earning pay. The five most common methods are salary, commission, piece-rate, bonuses, and hourly.

Salary. Someone that earns a **salary** is paid a *fixed, flat amount* for established time period (month, year, etc.). This means that the employee's pay will be the same for every paycheck, regardless of hours worked. For example: a starting teacher might make $37,000 per year, paid in 12 equal monthly payments. Regardless of how many hours that teacher works, he/she will only receive the $37,000 for that year.

Commission. Someone that is paid on **commission** is paid a *percentage of revenue generated for the business* by the employee. If you are paid on commission, the more business you generate (dollar volume) for your employer, the more you make. Being paid on commission is most common for people who work in sales. For example, a realtor makes a commission of 3% of the selling price for every house he/she brokers the sale for. If that realtor sells a house for a price of $200,000, he/she will make $6,000 on that sale; if he/she sells a house for $300,000, he/she will make $9,000 on that sale. The larger commission due to a higher selling price serves as an incentive for that realtor to negotiate as high of a price as possible with the buyer, benefiting both the seller and the realtor.

Piece-Rate. Pay by **piece-rate** is normally used for certain types of factory work where employee produces multiple units of the same product. That employee normally has a *standard amount* to produce a day (with a guaranteed daily pay), with an *incentive* for production beyond standard amount. An example of this would be an employee assembling computer mother boards who has standard production of 24 units per day with a guaranteed base pay of $96. Based on the guaranteed base pay and standard production amount, the incentive rate is $4.00 per piece ($96/24). If the employee produces 24 or fewer products, he/she gets paid $96 for the day (of course, if the employee habitually produces less than the standard amount per day, he/she runs the risk of getting fired). If the employee produces more than 24 in a day, he/she gets paid $96 plus an additional $4 incentive pay for each unit over 24 that he/she produces that day.

In factories in which the employee makes multiple copies of the same item, that employee may be paid in a piece-rate method instead of hourly. This seamstress would have a guaranteed daily minimum pay, but she would be paid extra for each garment beyond her assigned "standard quantity" that she produces during her shift.
(Image courtesy of Microsoft Photo Gallery)

Bonuses. If an employee is paid with a *bonus*, he/she receives a *bonus amount of pay for achieving goal*. The goal may be an individual goal, where an employee will receive a specific bonus tied to a specific goal. The bonus may be for a team, where a group of employees will all receive a bonus for achieving a specific goal. It may even be for an entire business, where all employees receive a bonus if the business as a whole achieves the goal. The goal to which the bonus is tied is most commonly a production or revenue goal, or it may be some other goal set by employer. For example, a business might promise that all employees will receive a $500 bonus if the business reaches a monthly revenue goal of $1 million. Payment by bonuses is normally not the primary method of earning pay for an employee; he/she earns most of his/her pay in one of the other methods, then may have the opportunity to earn more through bonuses.

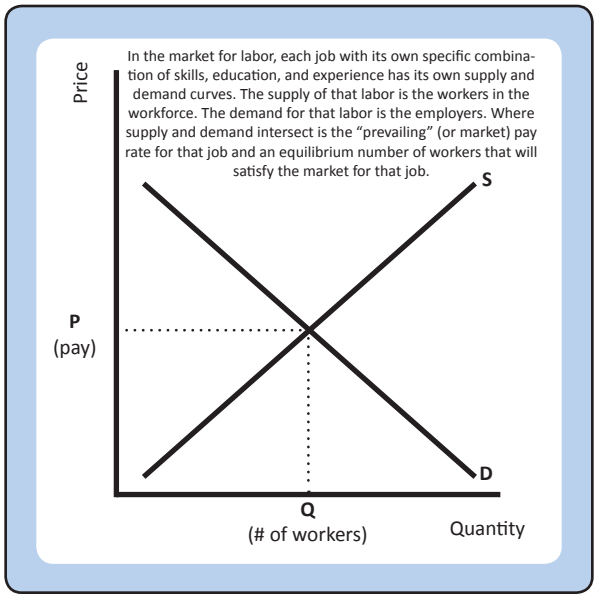
Hourly. Hourly pay is normally referred to as a **wage**. An "hourly employee" is paid a *specified rate for each hour worked*, and the employee's pay will fluctuate based on the numbers of hours worked. For example, a starting cafeteria employee makes $8.60 per hour. If that employee works 40 hours in a week, he/she will receive $344.00 ($8.60 x 40) in pay for those hours. Although there are a few exceptions, most hourly employees earn **overtime** for each hour worked per week in excess of 40 hours. When an hourly employee works overtime, he/she is paid 1 ½ times his/her base hourly rate for those overtime hours; this is commonly referred to as "*time and a half*". The previously-mentioned employee that earns $8.60 an hour, if he/she works 45 hours in a given week, will earn the $344.00 in regular wages and another $64.50 ($8.60 x 5 x 1.5) in overtime wages, for a total of $408.50 in total wages.

Some employers pay their employees using a combination of these methods. In addition to the possibility of earning a bonus on top of regular pay, some employers combine salary and commission when paying their sales representatives, promising the employee a base salary plus a commission on sales. Some might even pay an hourly rate plus commission; this is fairly rare, though, since employees filling sales-type positions (the most common recipients of commissions) are usually salaried employees, not hourly employees.

The Labor Market

There is a market for labor. The labor market works like any other market; the price paid for the labor is driven by Supply and Demand. The ***demand for labor*** is from the ***employer***. The Law of Demand applies to an employer's demand for workers: employers are willing to hire more qualified workers at lower pay rates than higher pay rates. The ***supply for labor*** is provided by the ***employee***. The Law of Supply applies to employees' supply of labor: employees more willing to take jobs at higher pay rates than lower pay rates.

One concept to keep in mind is that, when referring to the labor market for a specific job, the definition of that job goes beyond simply the description of duties. Also incorporated into that job is usually education, experience, and/or specific skills or other qualifications. For example, the labor market for a sales representative with no experience and no education requirements is different than the labor market for a sales representative that requires a bachelor's degree and three years' experience in mass media advertising sales, even though the basic description of the duties might be identical.



Factors Influencing the Supply of Labor

There are several factors that influence the supply of labor. Each factor has an influence on the quantity of labor that will be supplied for a specific job with a specific combination of experience, education, and/or skills/qualifications required for that job.

Required Skill Level. If a job requires a low level of skill, education, and/or experience to do, there will be a large potential pool of qualified employees for that job. If a job requires a high level of skill, education, and/or experience to do, there will be a small potential pool of qualified employees for that job. Jobs that don't require much skill, like a sales clerk at a convenience store, will have many more potential workers qualified to fill that position compared to a job as an accountant, which requires much more skill to do.

Working Conditions. For two jobs with identical skill, education, and/or work requirements, the number of applicants willing to put up with the worse working conditions is smaller than for the job with better working conditions. There are fewer workers willing to tolerate the working conditions for a job as a fast food clerk at an outdoor food stand in the summer than for a fast food clerk working inside an air-conditioned restaurant.

There are more workers who are potentially qualified to work as a fast food clerk than as a doctor. The supply of fast food clerks is greater than the supply of doctors.
(Images courtesy of Microsoft Photo Gallery)

Location & Cost of Living. Jobs in rural & less populated areas will have fewer people available for a given job. There is a much smaller pool of potential dentists in a very rural, sparsely populated county than there is in a major metropolitan area. Also, areas with a high cost of living will have a workforce that demands a higher wage for a given job compared to an area with a lower cost of living; for a given job, fewer workers will be willing to take a given job at a low wage, regardless of the qualifications needed for the job. A good example of this would be residents in major metropolitan areas in California. The cost of living there (rent, gasoline, groceries, etc.) is much higher than in Winchester, so workers there, in general, will demand a higher wage than those working an identical job in Winchester just because they will need to make more just to be able to afford to pay their bills.

Large metropolitan areas have more workers available than more rural locations. However, the cost of living tends to be higher in big cities compared to small towns. Both factors influence the supply of labor for a given job at a given wage.
(Images courtesy of Microsoft Photo Gallery and www.smalltowntravels.com)

Productivity of Worker. For a given job, there tends to be fewer workers with high productivity (output per unit cost) than with low productivity. A worker's level of productivity is directly related to the skills, education, & experience that he/she might have. Workers with more experience & education (and thus more skills) tend to have higher productivity; however, there are relatively fewer workers that have had the time to develop those skills, education, and experience that leads to that higher productivity. A computer network technician with 10+ years of experience is much better at his/her job, and is much more rare (relatively speaking) that a computer network technician who has just graduated school and has no experience and may not know how to do his/her job as well.

Factors Influencing the Demand for Labor

There are also multiple factors influencing employers' demand for labor. Each factor has an influence on the quantity of labor that will be demanded for a specific job with a specific combination of experience, education, and/or skills/qualifications required for that job.

Overall Demand for the Worker's Output. If the job to be done is something relatively few people need, the demand for that work will be low. For example, there is very little demand for a woodworker who specializes in hand-crafted furniture, since there are relatively few businesses that specialize in producing hand-crafted furniture.

Productivity of Worker. Employers want the best employees. Employees with the highest productivity (normally achieved through a combination of education and experience) will be in higher demand than those with lower productivity. This is because the cost per unit output will be less for more productive employees than for less productive ones. For example, a factory worker in a mattress factory who can produce 20 mattresses in an hour will be in much higher demand than a factory worker that can only produce 6 mattresses in an hour.

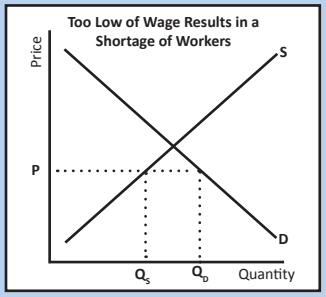
Factors Influencing the Demand for Labor

For a given job with a given level of skill, education, and/or experience required, the market for that job can be illustrated with the same supply and demand curves like any other "product". What the supply & demand curves for the labor look like (location on graph, steepness, etc.) will be dictated by the factors that influence supply & demand for it. Those supply and demand curves will intersect somewhere, and there will be a market equilibrium "price" (the pay) for that "product" (labor).

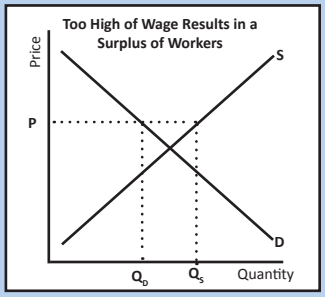
Of course, just like was discussed in Unit 4, the specific composition of the supply and demand curve, and the point of intersection, are almost impossible to graph accurately because the factors that determine both the supply of and demand for labor for that specific job are constantly changing. Therefore, the employer will offer a given level of pay (like setting the price for any other product). Let's say, for example, that one of the local trucking companies is trying to hire a properly licensed driver for one of its large trucks, and that company advertises the position as paying $9.25 an hour.

If the level of pay offered is too low, there will be a shortage of qualified applicants. In this case, the employer will have to raise the "price" (pay) to lure more "producers" (qualified applicants) into the market. In the case of the trucking company trying to hire a driver, $9.25 an hour is probably not enough to lure someone who has taken the time (and expense) to get trained on driving large trucks and has his/her Commercial Driver's License (needed to drive those large trucks). Chances are that the company will have few, if any, applicants for that job.

If the level of pay offered is too high, there will be a surplus of qualified applicants. In this case, the employer probably will lower the "price" because the surplus indicates that his/her wage is above market equilibrium. Sticking with our same example of a trucking company hiring a truck driver, if the company offered a wage of $30.00 an hour, they will probably get a large number of applicants, more than they reasonably expected. They are probably offering to pay too much for what the market is currently paying for that type of truck driver with that specific set of skills, education, and experience.



If the employer sets the pay (P) too low, he/she will have a shortage of qualified applicants. He/she will have to raise the pay to lure in enough qualified applicants. The pay rate for the job will move toward equlibrium.



If the employer sets the pay (P) too high, he/she will have a surplus of qualified applicants. He/she will probably lower the pay to drive some applicants out of the market. The pay rate for the job will move toward equlibrium.

Factors/Constraints on Pay

There are several considerations beyond the actual wage the employer will pay an employee. The employer considers these factors & constraints on pay when he/she is determining what pay he/she will offer for a given job.

Selling Price of the Employer's Product

Labor is one of the "costs of doing business" that is factored in to the price of the products produced by the employer. The market for that product is driven by those same Laws of Supply & Demand. Employers cannot raise price to cover additional labor costs without it having a negative effect on the quantity demanded. Therefore, employers will only hire (or continue to hire) as long as the benefit (increased sales, increased production, etc.) outweighs the cost (pay) for that employee.

Imagine you are a convenience store owner, and the only type of employee you have is a basic cashier who simply rings up sales. You currently have only one employee and you pay him $8.00 an hour. Labor costs are, on average, about 50% of the sales revenue for that convenience store. This means that, for each additional clerk you hire, that clerk needs to generate at least $16.00 per hour of additional sales in order to be worth the cost of his/her labor. This is more than just simply whether or not the sales clerk handles $16.00 per hour in sales; he/she must

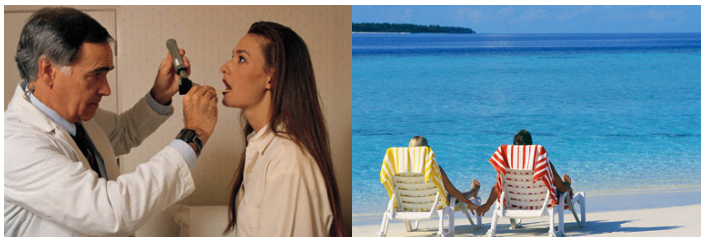
facilitate an *additional* $16 per hour in sales that would not have otherwise occurred because he/she was not working there (i.e. customers walking out due to long lines, customers not coming in and making purchases because they know they would have to wait longer than they want because the cash registers are understaffed at your convenience store).

Perhaps your store is understaffed, and adding a second cashier during busy times will make economic sense. Adding a third cashier may not make as much sense, though, unless that third cashier facilitates at least an additional $16.00 per hour in sales that would not have otherwise occurred with only two cashiers. There will be a diminishing marginal return for adding each additional employee, with each additional employee not necessarily facilitating as much in additional sales, because you (the owner) are limited in how many you can hire based on the demand for your products, and that demand is driven by the price of your products. If that additional employee is not covering his/her cost to you, you might need to raise the price of your products to help cover the cost of that additional employee; however, you know that because of the Law of Demand, you will sell fewer products if you raise your prices.

"Fringe Benefits" That Are Part of the Employee's Compensation

In many jobs, the employee receives more for working for that employer than what simply shows up in his/her paycheck. **Fringe benefits** are non-pay compensation offered to workers in addition to their pay. Some examples of fringe benefits are paid vacations, retirement plans, health insurance, or tuition reimbursement. All of these are costing the employer money, but these fringe benefits do not show up as income in an employee's paycheck.

The employee's paycheck might be smaller than if he/she was not receiving these fringe benefits. However, often the value of fringe benefit is usually greater than if employee had to pay for those same things out-of-pocket. For example, many employers can negotiate a group health insurance plan for their employees, and the employer actually pays for the insurance. Usually, the cost of this insurance plan is less than if the individual employee had to pay out of his/her own pocket. If the employer stopped offering health insurance for the employees, and instead increased each employee's pay by the amount that was originally being used to pay for the insurance, the employee that goes and purchases health insurance on his/her own actually comes out worse off than before. Even though his/her pay went up, he/she is spending more on the individual health insurance plan than the amount of his/her pay increase.



Fringe benefits like employer-provided health insurance or paid vacation time are costs to the employer that are not reflected in a paycheck but are factors they consider when determining how many employees they can afford to hire, and for what pay (including benefits).
(Images courtesy of Microsoft Photo Gallery)

Employer Costs for Employees

The cost of employee to employer is not simply the pay plus the cost of fringe benefits. The government requires employers to pay or provide the following:

- The employer matches each employee's Federal Insurance Contributions Act (FICA) contributions to Social Security (6.2% of pay) and Medicare (1.45% of pay); this comes from the employer, not the employee.
- The employer must pay a total of 6.2% of the first $7,000 of each employee's annual pay for Federal and State Unemployment Insurance.
- For most businesses, the employer must carry (and pay for) Worker's Compensation Insurance to pay for any work-related illnesses, injuries, or death suffered by his/her employees. The cost of this insurance varies by state and occupation, and for some dangerous jobs, the cost can be quite substantial.
- There are other possible costs, based on federal, state, and/or local mandates.

These additional costs drive up the labor cost of that employee. For an employee only earning $7.25 per hour with no fringe benefits, the actual cost to the employer for that employee is $8.23 per hour (the original $7.25 + an additional 13.45% of that wage for the employer contributions), not including what the worker's compensation insurance cost might be. As the wage of the employee goes up, these employer costs also increase by 13.45% of whatever the wage is. This can prove to be quite costly to an employer that is paying higher wages, and this additional cost must be covered by additional revenue generated by the employee and/or an increase in price (which will result in a lower quantity demanded, and may actually result in lower overall dollar sales).

Minimum Wage

The Federal Government has set a minimum wage of $7.25 an hour (with limited exceptions allowed). Some states actually set the minimum wage in their state even higher. For some labor, this may be above what the market equilibrium would be for that job if the market was allowed to operate without interference. The result of this is the same as what happens in a product market when the price is set above market equilibrium: a surplus of potential employees for that job occurs (a higher unemployment rate for workers in that field).

The resulting surplus of applicants due to a minimum wage above equilibrium gives the employer a greater ability to hire the employees with the highest potential productivity to maximize output (sales, units produced, etc.) per unit of input (wage) because of such a large applicant pool. However, workers with less experience & skills (teenagers, less educated, etc.) are "priced out of the market" because they are competing against more skilled employees who wouldn't be there if the wage was lower.

For certain labor markets where the minimum wage is above equilibrium, both employers and applicants are hurt. Fewer applicants get hired because the employer is limited in how many additional employees he/she will be able to afford to hire at that higher rate. These lower-paying jobs are generally jobs where little (or no) skill, education, and/or experience are needed. These are normally entry-level jobs or jobs that are first jobs for young employees. Those potential employees have greater difficulty getting an entry-level job that will allow them to build the work history, skills, and experience they will need to be competitive for higher-paying jobs. The minimum wage becomes a barrier to entry to the job market for many less skilled, less experienced applicants.

Teenagers, some minority groups, and other low-skill/low-experience applicant groups have historically experienced higher than average rates of unemployment, often having difficulty even getting their foot in the door of the job market so they can develop the work skills and habits, and build an employment history, that most employers are seeking in their employees.
(Image courtesy of MSNBC)

How Changes in Supply & Demand for Goods & Services Affect Income

As an employee, you should know that changes in both the supply of and demand for your employer's goods and services can affect your income. You have the potential to make more or less income, sometimes without seeing a change in your hourly wage, due to changes in your hours worked.

Changes in Demand

Remember, demand is the term used to refer to the market demand for a good or service, which is the sum total of the quantities that would be demanded at all prices. A demand shifter is that condition that changes the market demand for the product, resulting in more (or less) of that product being demanded at all prices.

Demand for the productive resources (land, labor, and capital) due to a change in demand for a firm's goods & services is called **derived demand**. When demand for a firm's goods & services goes up, demand for the labor needed to produce those goods & services goes up. This will lead to an increase in the incomes of those workers due to overtime and/or an increase in wages to keep those workers.

Suppose you are an hourly worker at an automobile factory and there is a significant increase in demand for automobiles worldwide. Chances are, your factory will need to ramp up production to meet the increased demand. They may start having you work more overtime (at 1 ½ times your regular wage) as they run the assembly line longer, possibly on weekends. If the increase in demand is sustained, and you are skilled at what you do, the company may have to raise your wage to prevent you from being lured away to one of their competitors (who also may demand your labor to help them increase their production due to increased demand). This will result in an increase to your pay.

When demand for a firm's goods & services goes down, demand for the labor needed to produce those goods goes down. This will lead to a decrease in the income for those workers since their work hours may need to be cut back. For the same automobile factory, they may need to reduce production to avoid producing surplus automobiles that won't be selling. They may need to cut back on the number of hours they run their production line . This will result in smaller paychecks for you.

Changes in Supply

Remember, supply is the term used to refer to the market supply for a good or service, which is the sum total of the quantities that would be supplied at all prices. A supply shifter is that condition that changes the market supply for the product, resulting in more (or less) of that product being supplied at all prices.

If overall supply for a product increases, this could lead to an increase in workers' incomes. Workers may get additional hours (including overtime) to provide that increased production. Suppose you work for a business that produces smartphones. If some change in technology makes the cost of the microchip processor needed to run that smartphone goes down, your business may react to this reduction in the cost of that input by increasing production (based on the Law of Supply and how a supply shifter affects the market supply of a product, discussed in Unit 4). Just like when production is increased due to an increase in demand, workers will generally see an increase in hours worked, and

possibly an increase in their wages, due to the increase in supply, ultimately leading to larger paychecks.

If overall supply for a product decreases, this could lead to a decrease in workers' incomes. Workers' hours may get cut back due to decreased production needs (especially if the decrease in supply temporarily results in an excess inventory that needs to be depleted). Suppose you worked in a factory that produced items made from corn (corn meal, high fructose corn syrup, etc.). If there is a huge drought in the U.S. Midwest that destroys much of the corn crop, this drives up the cost of corn and reduces the availability of corn to use in your factory. With the higher costs of the input (corn) and the reduced availability of corn, your factory will probably cut back on production. The result will probably be reduced hours for you, resulting in smaller paychecks for you and your fellow workers.

Increases in demand for or supply of an employer's product usually result in more hours (and a larger paycheck) for employees.
(Image courtesy of www.theautoabc.com)

How to Increase Your Human Capital

Human capital is the combination of education, experience, and skills/qualifications you have to offer a potential employer. The more human capital you have, the more appealing you are to a potential employer who seeks someone with your abilities. This will allow you to command higher pay for your efforts on behalf of that employer. You can increase your human capital, making yourself more desired by potential employers.

The Starting Point: Aptitudes, Interests, & Aspirations

Aptitudes are *what you are good at*. **Interests** are *what you like to do*. **Aspirations** are *what you hope to accomplish in your working life*. Do an honest self-evaluation of your aptitudes, interests, and aspirations. You can do career surveys to help identify careers that align with your aptitudes, interests, & aspirations. Just because you love animals does not mean you will make a good pet store owner; you may lack the specific aptitudes (organization, time management, attention to detail, ability to work with financial data) needed to be a successful entrepreneur. A good career survey will be able to identify the things you like, that you do well, and that you aspire to do, and it may identify potential careers that you may not have otherwise considered.

Become Qualified: Education, Certification, & Licensing

A more advanced education will help you progress even further. Colleges, such as Community College, a 4-Year College, or University at which you earn an Associate's Degree, Bachelor's Degree, or advanced degree will allow you to earn a degree. Having one of these degrees historically has resulted in higher lifetime pay and lower unemployment rates than careers for which advanced education is not required. Specialized schooling for those not well suited for a college education, such as Trade Schools, Technical Institutes, and Job-Training Programs can provide you highly technical, highly sought-after skills that are always in high demand (and earn higher pay) in the modern U.S. economy. Online programs, whether collegiate or technically-oriented, offer a modern alternative to traditional classroom instruction.

Certification & Licensing is official recognition that a person is qualified in his/her field. Some examples are Registered Nurse (RN), Doctor (MD), Microsoft Certified Systems Engineer (MCSE), Automotive Service Excellence (ASE), and even a Teaching License. Certification and licensing is a good way for aspiring professionals to show their competence and commitment to their field. As with advanced education, people with certifications and licensing tend to earn a higher income, and experience lower rates of unemployment, than those workers without them.

Industry certifications and licensing, like Automotive Service Excellence (ASE) certifications for mechanics or medical licenses like MD or RN, are ways for workers in specialized fields to demonstrate competence.
(Images courtesy of Microsoft Photo Gallery)

Gaining Work Experience & On-the-Job Training

Employers often look for people who have significant experience & have developed useful job skills. Wages tend to rise the longer a person has been in the labor force. A worker with a great deal of work experience and job skills will make more than someone lacking those skills and experience.

Some employers prefer to hire more experienced employees and pay them a higher wage to start, and that worker will usually get pay raises the longer he/she has been with that employer and proves his/her value to that employer.

Some employers, though, prefer to hire inexperienced workers & train them on the job. Most entry-level jobs don't pay much; however, most employees don't stay at that entry level job or pay level long, and this is a good way to develop job skills & build work experience. Just because you get hired at what you might consider a "low" amount of pay, know that you won't stay at that level of pay for very long; generally, most employers will start an untrained, untested employee at a low wage, then will provide pay raises as that employee proves his/her ability to do the job and his/her value to the employer.

Increasing Personal Productivity: Effort & High Standards

Once a worker gets a job, the task of developing a marketable work history that will be desired by the current (and future) employers is just beginning. The level of energy & enthusiasm workers bring to a job also increases their value to employers. Some jobs reward workers based on how much they produce, whether it be commissions, bonuses, and/or performance-based pay raises. Also, developing a reputation for being a hard worker with high standards can help you get your next job by getting you a good reference from your previous employer.

Building a Personal-Professional Network

This is commonly referred to as networking. **Networking** is the process of developing personal and professional contacts that has the potential to benefit you in your career, whether it is discovering a job opportunity through that contact or possibly finding a potential client for your company. Professional organizations and associations are a good way to meet colleagues. Involvement in community organizations is also a good way to expand your connections in the community. This can be done through volunteering, community involvement, and even recreation league sports teams. All of these organizations are good ways to develop new job contacts or discover professional growth activities.

Networking through professional organizations or community involvement is a good way to meet professional contacts.
(Images courtesy of www.interviewangel.com and Operation Gratitude)