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An Outline of a Compensation System Based on Human Capital Theory

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Abstract

The paper presents the identification and definitions of compensation functions from the perspective of human capital theory. The methodology for achieving the objectives of work is based on an alternative human capital model. This model facilitates explicit assessment of employees' individual human capital based on the achievements of accounting in the area of valuations. The model identifies human capital as aggregated capital related to the costs of living, education and professional experience. Recruiting an employee implies the use of human capital in a business process, which makes employers responsible for offering appropriate compensation – the product of human capital value and the adopted rate of return. Fair base compensation requires the adoption of a rate of return at the level of potential growth.

Also, the model offers the methodology for evaluating a bonus compensation fund in relation to the company's financial parameters. It is facilitated by an appropriately formulated production function in additive form. The calculated value of a bonus fund does not distort the company's financial equilibrium. The applied methodology and concepts make it possible to identify the right balance between the four key functions of compensation: cost, income, social and motivating functions.

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Keywords: compensation functions, human capital measurement, base compensation, bonus compensation;

1. An alternative human capital model as a research programme

According to classical definitions, economic sciences including management sciences analyse the processes related to wealth generation and distribution. This objective, apart from the elapse of time, remains valid, and – importantly - wealth generation and distribution are closely interlinked. Wealth generation mainly indicates production processes and growth understood in broad sense at all economic levels including both international

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unions and micro business activities. However, maintaining an optimal pace of growth requires adopting a responsible system for participation in the manufactured products. In other words, it requires an appropriate system for distributing the generated wealth. A compensation system is one of the major mechanisms for income distribution. Compensation systems, an area of research in management sciences, include compensation strategies, practices and procedures. In practice, organizations implement their own systems, but their frameworks reflect the functioning of labour market institutions in a given business environment. Moreover, there are general limitations and superior principles the adherence to which contributes to organizations' long-term equilibrium. The paper presents an analysis of compensation understood as the equivalent of the use of employees' human capital. The starting point for our analyses is the definition of human capital.

Human capital is one the most frequently researched areas in economic sciences in the last decades. The dominant research area is the one undertaken by T. Shultz and G.S. Becker, marked by the concept of investing in people (Blaug M., 1995). This programme has led to researching a number of economic issues including education and family economics. It should be noted, however, that unlike in the alternative research approach presented by the Authors, traditional research studies do not give much attention to the concept of "capital". Many authors offer vague definitions of capital, referring to it as something that is undoubtedly positive and valuable. This simplification has resulted in a great number of traditional research programmes focused on various economic problems. However, a comprehensive analysis of key economic issues, e.g. the triad: capital-labour-money, requires a scientific research study of capital preceded by a description of its characteristics.

The starting point for formulating a proper theory of capital is the statement that capital – unlike specific and heterogeneous assets - is abstract, aggregated and homogenous in character (Ijiri Y., 1995). This differentiation is reflected in the 5-century-old accounting principle of asset-capital dualism. Capital defined as the ability to perform work is represented by resources, while capital concentration in a given facility determines its value.

Capital is a dynamic category, and its understanding requires identifying the factors which have an impact on changes to its value, especially the time factor. A dynamic model of capital changes is presented by formula (Dobija M., 2011):

$$C_t = C_0\, e^{rt} = C_0\, e^{(p-s+m)t} \quad (1)$$

(description below)

Capital is subject to three key environmental factors: natural capital flow subdued to spontaneous diffusion (s), factors diminishing the impact of destructive forces as a result of work and management (m), and an 8% natural potential growth (p). These factors can increase the initial value of capital (C_0) or lead to its dispersion. Another important implication of the presented model is the fact that capital dose not originate from "nothing" – it originates from initial capital (C_0).

Human capital is based on capitalised resources necessary to build the economic potential aimed to perform work by humans. In the first place, it includes the costs of professional education increased by the costs of living. It is necessary to incur the costs of living to prepare the physical carrier of human capital – the human body. Costs are incurred in time (t), which is necessary to prepare people to perform a given profession – from the time of birth to the moment of starting a professional career. If the human body is well prepared and a young person completes his/her education as planned, it indicates that capital diffusion (s) is compensated for by parents' efforts (parameter m). A formula of capital can be developed for employee (H_t), where initial outlays are represented by (H_0), constant economic value (p) and capitalization time (t):

$$H_t = H_0\, e^{pt} \quad (2)$$

This human capital model can be further extended to represent capital as the sum of capitalised costs of living (K) and education expenditures (E). These outlays lead to the ability to perform work, and this ability increases in the course of gaining experience. The supplementary formulas represent the development of human capital based on the costs of living K and education costs E:

$$H(T) = (K + E) \cdot (1 + Q(T)) \quad (3)$$