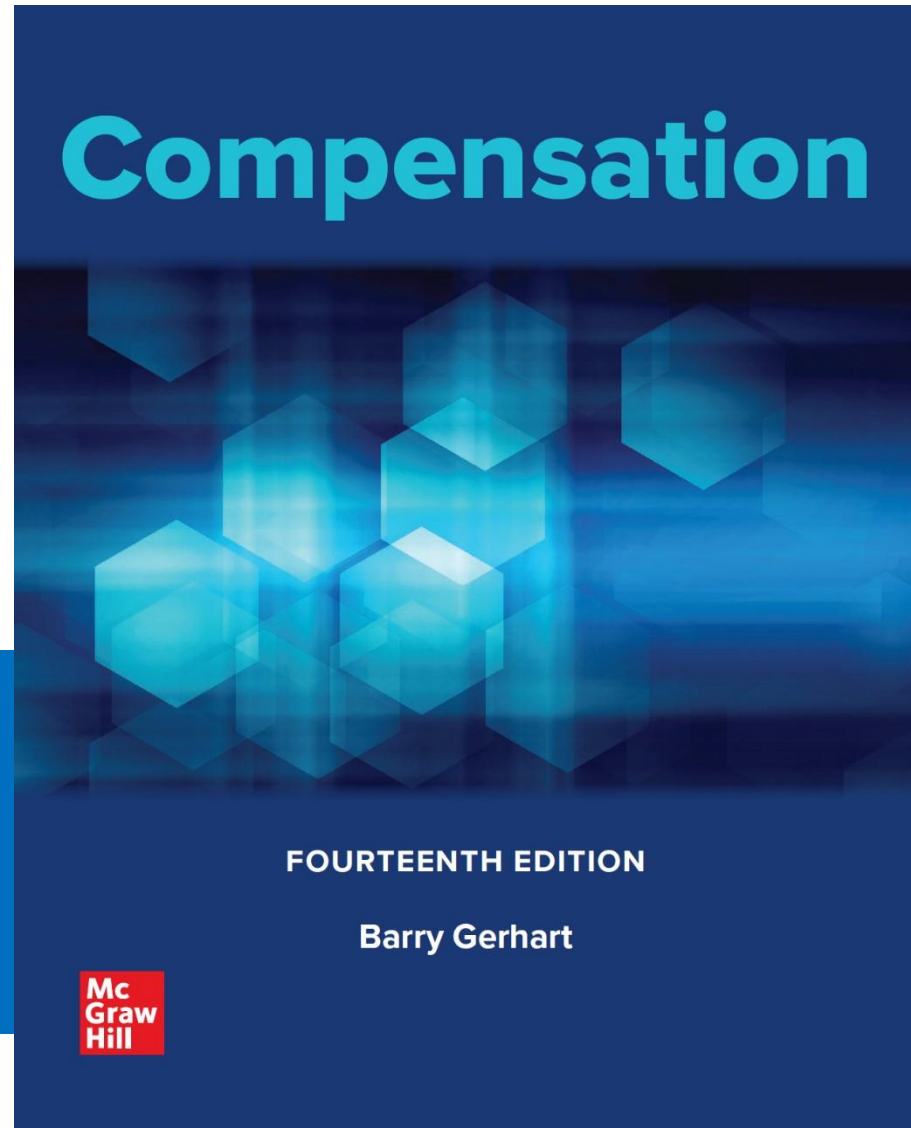




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Chapter 1

The Pay Model



Compensation: Does it Matter? (Or, “So What?”)

Recent failed companies had labor costs higher than competition without corresponding advantages in efficiency, quality, and customer service.

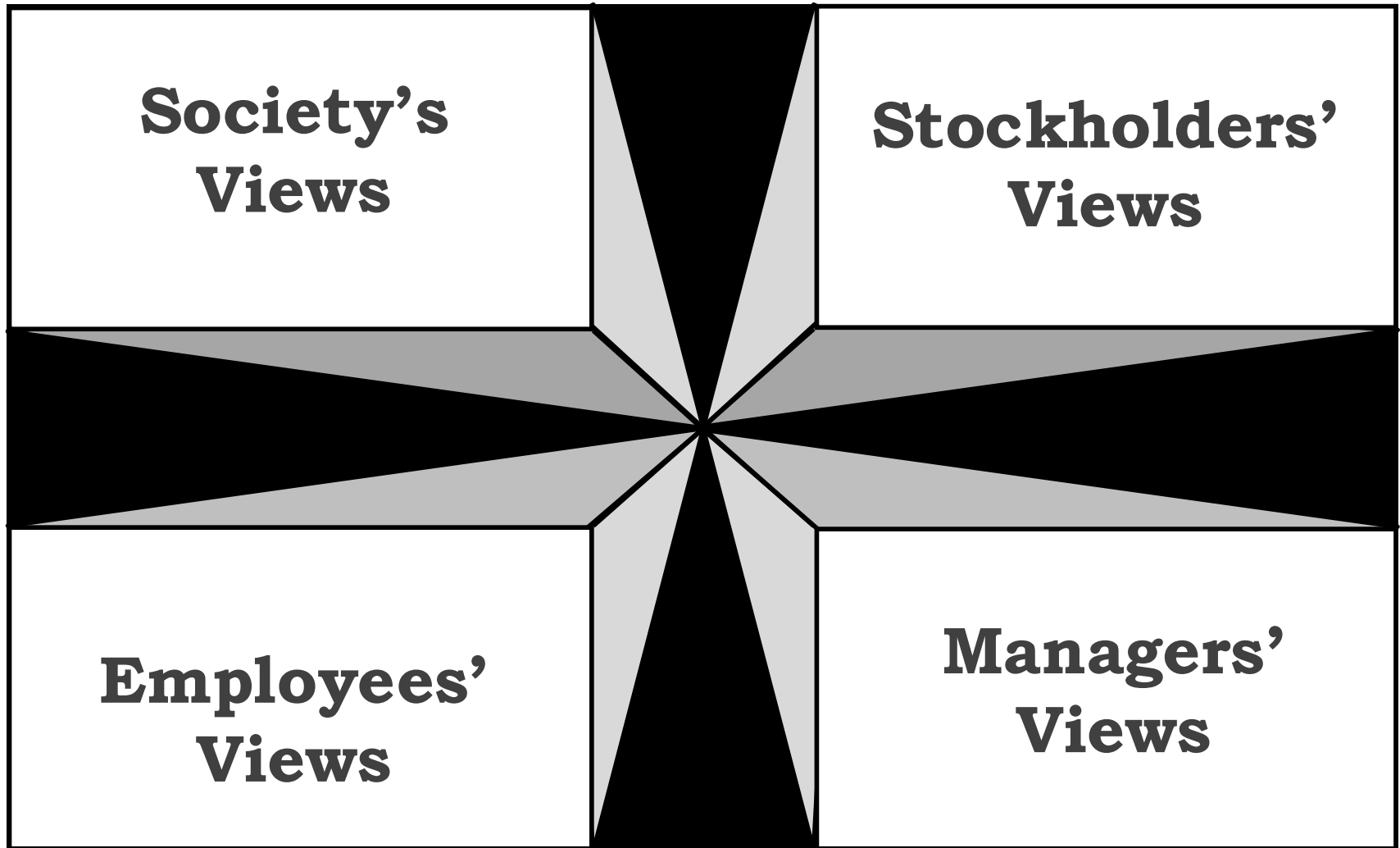
- Successful companies had relatively high pay as well as higher productivity compared to competitors.

Financial services firms and banks used **incentive** plans that rewarded people for developing “innovative” new financial investment vehicles.

- Novartis offered improper inducements to persuade doctors to prescribe Novartis drugs.

How people are paid affects their behavior at work, which affects an organization's success.

Perspectives of Compensation



Compensation: Definition, Please (Stakeholders) Society

Some people see pay as a measure of justice.

- Male/female earning differentials.

Does pay matter, but only up to a certain point?

- One study found paying more than \$95,000 had severely diminishing returns on *happiness*, yet a steady rise in *life evaluation*.

Benefits given as a part of total compensation may also be seen as a reflection of societal equity or justice.

- Private sector employers spend about 42 cents for benefits on top of every dollar paid for **wages** and **salaries**.

Job losses or gains in a country over time are partly a function of relative labor costs (and productivity) across countries.

Some consumers know that pay increases often lead to price increases.

Compensation: Definition, (Stakeholders) Stockholders

- Stockholders differ on if employees should be given stock options.
- Stockholders have a particular interest in executive pay.
- Shareholders influence executive compensation decisions through shareholder proposals and election of directors in proxy votes.

EXHIBIT 1.3 Annual Compensation of Chief Executive Officers, U.S. (S&P 500) Public Companies

	Median
Compensation Component	
Salary	\$ 1,200,000
Bonus	\$ 2,000,000
Stock Grants	\$ 6,500,000
Stock Option Awards	\$ 0 ^a
Total Annual Compensation	\$ 12,300,000

^aThe mean was \$2.0 million.

Compensation: Definition, Please (Stakeholders) Customers

Compensation is often the largest single operating cost.

- For companies whose business strategy depends on low product/service cost, they may focus on low compensation costs.

Compensation also comes into play for customers who want to purchase from a company that acts with responsibility.

- Customers may base their buying decisions on how they believe the company treats their employees, or those in their supply chain.

Compensation: Definition, Please (Stakeholders) Managers

Managers view compensation as influencing their success in two ways.

First, compensation is a major expense that needs managing.

- Competitive pressures force managers to consider the affordability of compensation decisions.
- Labor costs as a percent of total costs vary among individual firms.

Second, a manager can use pay to influence employee behaviors and to improve the organization's performance.

- High pay, if it brings high returns, is one strategy.
- Pay affects quality of work, attitude toward customers, and willingness to be flexible, learn new skills, or suggest innovations.
- Pay also may drive employees to unions or even legal action.

Compensation: Definition, Please (Stakeholders) Employees

Employees may view compensation as:

- *A return in an exchange* between their employer and themselves.
- As an **entitlement** for being an employee of the company.
- As an incentive to take/stay in a job and invest in performing well.
- Or as a reward for having done so.

The importance of pay is apparent in many ways.

- Wages and benefits are a major focus of labor unions' efforts.
- There is a legal framework governing pay: minimum wage, living wage, overtime pay, and nondiscrimination regulations.
- Points to the central importance of pay to employees in the employment relationship.

How Pay Influences Behaviors: Incentive and Sorting Effects

Pay influences employee **motivation** and behavior in two ways.

- Pay can affect the motivational intensity, direction, and persistence of current employees.
- Motivation, together with employee **ability** and work/organizational design, determines employee behaviors such as performance.

This effect of pay is known as **incentive effect**.

Pay can also have an indirect, but important, influence via a **sorting effect** on the composition of the workforce.

- It is not only how much, but *how* an organization pays that can result in a sorting effect.

The question for organizations is simply this: Are you using the pay policy that will attract and retain the types of employees you want?

- The pay model includes compensation policies and the **objectives** (efficiency, fairness, compliance) these are meant to influence.

Global Views—Vive la Différence

In English, compensation means something that counterbalances, offsets, or makes up for something else.

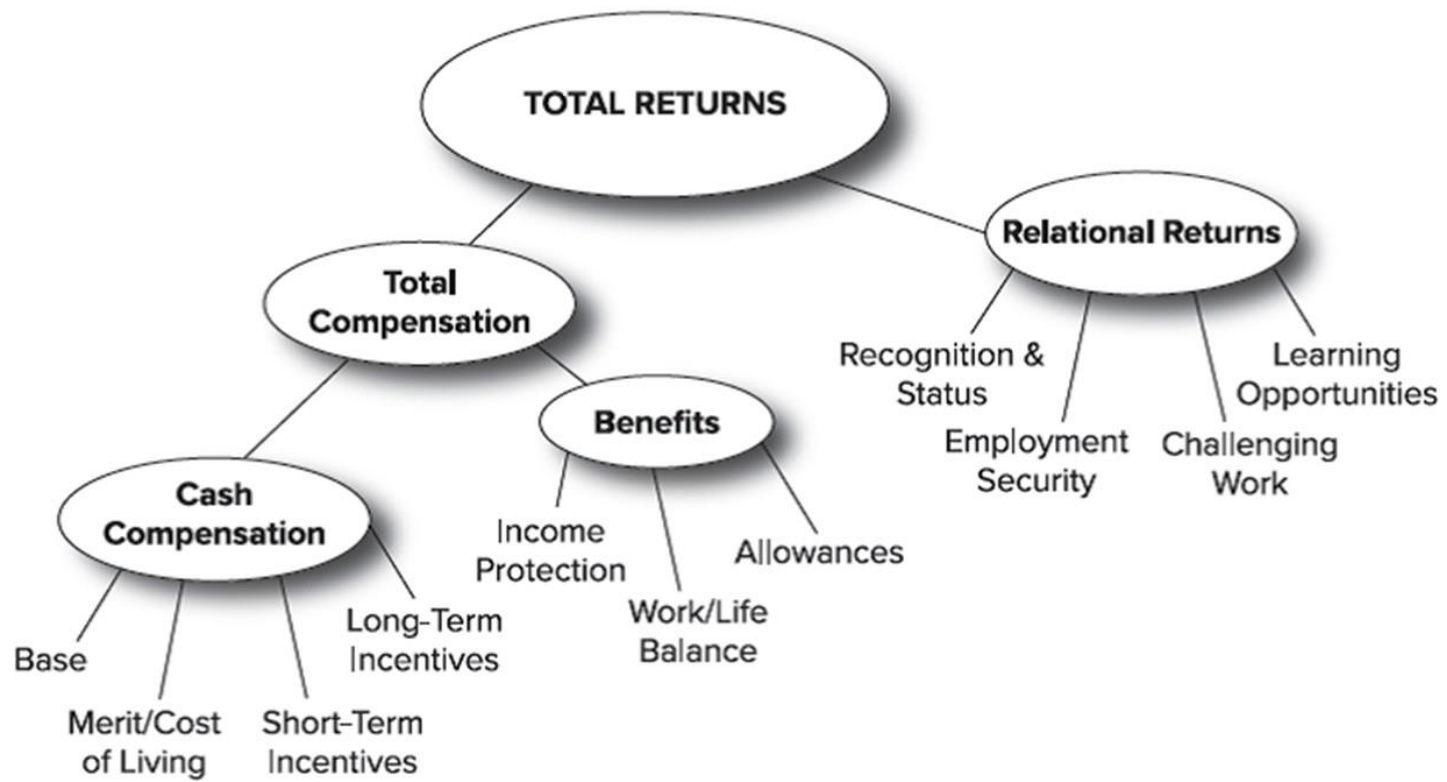
- In China, the characters for “compensation” are based on symbols for logs and water; meaning compensation provides the necessities in life.
- “Compensation” in Japanese is *kyuyo* which means “giving something.”

The following definition of “compensation” or “pay” is provided:

- **Compensation** refers to all forms of financial returns and tangible services and benefits employees receive as part of an employment relationship.

Forms of Pay

Total returns are categorized as **total compensation** and **relational returns**.



[Access text alternative for this image.](#)

Forms of Pay Cash Compensation: Base

Base wage is the cash compensation an employer pays for work performed.

- It reflects value of work or skills and ignores employee differences.

Salary refers to pay given to those who are **exempt** from regulations of the Fair Labor Standards Act and exempt from overtime pay.

- *Nonexempts* have their pay calculated on an hourly wage.
- Some organizations believe an “all-salaried” workforce reinforces an organizational **culture** where all employees are part of the same team.
- This does not negate the need to comply with the FLSA.

Forms of Pay – Cash Compensation Merit Increases/Short-Term Incentives/COLAs

A *cost of living adjustment (COLA)* to base wages may be based on:

- Changes in what other employers are paying for the same work.
- Changes in living costs.
- Changes in experience or skill.

Merit increases are given as increments to the base pay and are based on performance.

- Merit payments are based on an assessment of recent past performance.

Companies increasingly use *merit bonuses*.

- These are based on performance rating but are paid in the form of a lump sum rather than becoming (a permanent) part of the base salary.

Forms of Pay Cash Compensation: Incentives

Incentives also tie pay increases to performance but differ from merit adjustments in that they rely on an objective measure of performance.

- They do not increase base wage and must be re-earned each period.
- The potential size of incentive payment will be known beforehand.
- A Toyota salesperson knows the **commission** on a Land Cruiser versus a Prius prior to making the sale.
- Incentives explicitly try to influence future behavior.

Incentives can be tied to the performance of an individual employee, a team, or a business unit.

- One-time payments, no increased labor cost.
- Frequently referred to as **variable pay**.

Incentives can have powerful effects, both good and bad.

Forms of Pay Cash Compensation: Long-Term Incentives

Long-term incentives try to focus employee efforts on multiyear results.

- Typically in the form of stock ownership or options to buy stock at a fixed price.

Stock options are often the largest component in an executive pay package.

- Some companies extend stock ownership beyond the ranks of executives.

Forms of Pay Benefits: Income Protection

Benefits, including income protection, work/life services, and allowances, are also part of total compensation.

- Some income protection programs are legally required in the U.S., such as disability insurance or unemployment insurance.
- Employers also make half the contributions to Social Security.

Medical insurance, retirement programs, life insurance, and savings plans are common benefits.

- They help protect employees from financial risks inherent in daily life.
- Often companies can provide these protections to employees more cheaply than employees can obtain them for themselves.
- Employers have sought to reduce benefit costs by shifting costs to employees.

Forms of Pay Benefits: Work/Life Balance and Allowances

Programs that help employees integrate their work and life responsibilities include:

- Time away from work.
- Access to services to meet specific needs.
- Flexible work arrangements.

Responding to the changing workforce demographics, many employers are giving a higher priority to these benefits – reinforced by the pandemic.

Allowances often grow out of whatever is in short supply.

- In Vietnam and China, housing and transportation allowances are frequently part of the pay package.
- In many European countries, managers assume a car will be provided.

Total Earnings Opportunities: Present Value of a Stream of Earnings

Up to this point compensation has been treated as something paid or received at a moment in time.

- But a firm's compensation decisions have a temporal effect.
- You accept a job offer at \$50,000 a year.
- If you stay for five years and get an increase of 4% a year, in five years you will be earning \$60,833 a year.
- For your employer, the five-year cost commitment is \$331,649 and then add an additional 30% for benefits for over \$430,000.

A present-value perspective shifts the comparison of today's initial offers to consideration of future bonuses, merit increases, and promotions.

Forms of Pay Relational Returns from Work

Non-financial returns from work have a substantial effect on employees' behavior.

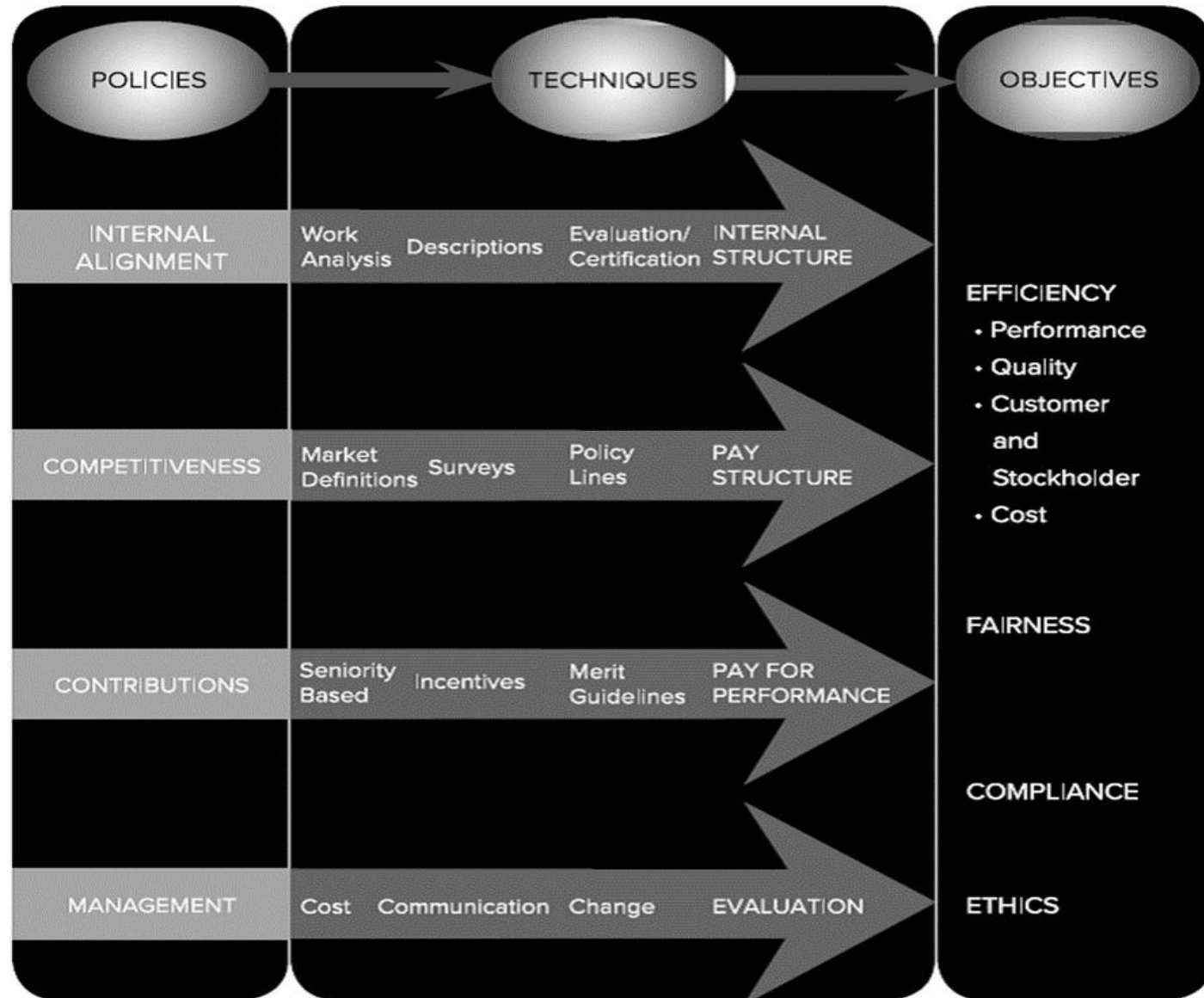
- Relational returns from work include recognition and status, employment security, challenging work, and opportunities to learn.
- Other forms might include satisfaction from facing new challenges, teaming with great co-workers, and receiving new uniforms.
- Such factors are part of the total return, which is a broader umbrella than total compensation.
- “Motivational purity bias” happens when candidates are evaluated lower when they seem to be motivated only by money.

The Organization as a Network of Returns

You can view an organization as a network of returns created by all the different forms of pay, including total compensation and relational returns.

- The challenge is to design this network so that it helps the organization to succeed.
- The network of returns is more likely to be useful if bonuses, development opportunities, and promotions all work together.
- As a potential employee, look beyond the cash and health care offered to search for all the returns that create the network.

A Pay Model



This pay model serves as both a framework for examining current pay systems and a guide for most of this textbook.

Compensation Objectives

Efficiency: improving performance, increasing quality, delighting customers and stockholders, and controlling labor costs.

Fairness: (sometimes called equity) is a fundamental objective of pay systems—both *procedural* and *distributive*.

Compliance: conforming to federal and state compensation laws and regulations.

Ethics: the organization cares about how its results are achieved.

Pay objectives guide the design of the pay system.

Objectives also serve as the standards for judging the success of the pay system.

Four Policy Choices

Internal alignment refers to comparisons among jobs or skill levels inside a single organization.

- Pay relationships within the organization affect all the pay objectives – caps can manage differences in **total cash** compensation.

External competitiveness refers to pay comparisons with competitors.

- Decisions here allow employee recruitment and retention and control labor costs to remain competitive.

Emphasis placed on **employee contributions** (or nature of **pay mix**) directly affects employees' attitudes and work behaviors.

- Can include a **flat rate** pay or **team incentives**, but ideally should be decided in conjunction with external competitiveness decisions.

Management means ensuring that the *right people* get the *right pay* for achieving the *right objectives* in the *right way*.

Pay Techniques and Book Plan

The remaining portion of the pay model shows the techniques used to make up the pay systems.

- Techniques tie the four basic policies to the pay objectives.
- Uncounted variations in **pay techniques** exist.