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Compensation

To all our loved ones.

Preface

Contemporary society is increasingly interested in how organizations allocate the returns from work. At the same time, a changed economic climate is forcing organizations to review the way they manage and pay people. The result is greater attention to the compensation function and a more proactive attitude toward the role of pay in determining organizational effectiveness. Compensation decisions are being integrated into the entire strategic planning process. Conscious efforts are being made by compensation professionals to develop policies which will recognize effective work behaviors and accomplish organization objectives.

This dynamism is both a boon and a source of frustration for compensation managers. On the positive side, compensational professionals have the opportunity to make decisions with dramatic bottom-line impact. But these opportunities can also be a source of frustration. Very simply, the number of compensation decisions which can be made in a cookbook approach, if ever any existed, is rapidly dwindling. Pursuit of the single correct answer is futile. There are multiple correct answers which are more or less viable depending on an analysis of the uniqueness of both the organization and its environment. And organizations and environments are constantly changing.

This book recognizes the complexity of compensation decisions. We do not present solitary approaches where multiple ones exist. Nor do we assume that compensation decisions occur in a vacuum. Rather, we describe a wealth of input data and potential outcome effects to be considered in making any compensation decision.

The design of this book is largely based on the concept of equity. As the pay model in Chapter 1 illustrates, equity takes on many and varied forms. Each of the first three sections of this book takes a different component of equity (internal equity, external equity, and employee equity) and discusses the major compensation issues requiring resolution. Each of these discussions is placed in the context of research and state-of-the-art practices to guide compensation decision making.

The final two parts of this book cover employee benefits and administrative issues in compensation. These are topics of increasing importance. First, costs of employee benefits are rising rapidly. Our coverage reflects the increased knowledge, activity, and concern in this area. Second, as compensation decisions come increasingly into the limelight, compensation managers must be accountable for and able to justify their recommendations in terms of their effects on business strategies and objectives.

The preparation of this book relied upon the contributions of many people. We owe a special debt of gratitude to our students. In the classroom they motivate and challenge us, and as returning compensation professionals, they try mightily to keep our work relevant.

Several practicing compensation professionals in many different organizations shared their ideas and practices with us. Some commented on early drafts of chapters, others shared details about particular problems and projects. While we cannot hope to recognize all of them, a few who went beyond the call include Al Bellack, Steve Kumagai, David Ness, Ron Page, Ken Ross, Ray Olsen, George Schmidt, Dave Wessinger, and Steve Wolf.

Several academic colleagues also helped. Detailed comments by George Bohlander, Chris Berger, John Fossum, and Sara Rynes were particularly useful. Renae Broderick, Michael Gold, Bob Risley, Brian Cartwright, Cynthia Fukami, and Janice Mackey reviewed specific sections, and their comments strengthened the book. We also wish to recognize Dave Belcher, who influenced the thinking of many compensation professionals, including us.

Josephine Churey, Lynn Johnson, Chris Smith, Janice Bukowski, Nancy King, Sharon Murawski, and Sue Wolf all assisted in manuscript preparations. Our deans, Charles Rehmus (Cornell) and Joe Alutto (SUNY Buffalo), and department chair Howard Foster (Buffalo) provided a supportive work climate, for which we thank them. And Thelma Newman and Terrie Newman provided special assistance under deadline pressures.

While not emphasized in the book, the first author advocates the family unit as an economic unit, and he acknowledges the contributions of Michael and Matthew Milkovich to this project.

The authors owe a special debt to Carolyn Milkovich. Without her administrative and editing talents and her constant prodding and encouragement, the book would never have been completed.

George T. Milkovich
Jerry M. Newman

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Chapter 1

Strategic Issues and the Pay Model

Chapter Outline

Think of an employer, any employer—from Burlington Northern Railroad to Ralph's Pretty Good Groceries—and consider the array of wages paid. Burlington Northern's wages differ for different jobs ranging from locomotive engineers, laborers on maintenance-of-way gangs, accountants, traffic clerks, to nurses. Similarly, Ralph's pays wages to checkout clerks, produce department managers, and butchers.

Why do some employers pay more (or less) than other employers? Why are different jobs in the same organization paid differently? And why do different workers doing the same job receive different pay? How do these decisions get made and who is involved? What are the consequences of these decisions for the employer as well as the employee? These questions were so interesting to Mary Lemons, a Denver nurse, that she took her employer, the city of Denver, to court, alleging that it was illegal to pay its tree trimmers (all men) more than its nurses (mostly women). Compensation, whether it's your own or someone else's, is a fascinating topic.

Compensation professionals are immersed in one of society's greatest challenges—the fair and equitable distribution of the returns for work. As already noted, compensation decisions are many and varied. They include how much to pay people who perform both similar and different types of work; whether to recognize with pay variations in individual employees such differences as experience and/or performance; and how to allocate pay between cash and benefits and services. Such basic decisions must be made by every employer, no matter how large or small. Furthermore, these decisions must be consistent with society's changing values about what constitutes fair and equitable pay as well as with government legislation and regulations. Consequently, decisions about compensating people for the work they perform are increasingly complex, and so, too, are the skills required to make those decisions.

This book is about the management of compensation—the decisions that go into paying employees, the concepts and research underlying those decisions, the alternative techniques used to help make decisions, and the objectives obtained. Its purpose is to help you gain the background required to make these pay decisions. Let us start with what is meant by compensation.

COMPENSATION IN CONTEMPORARY SOCIETY

Perceptions of compensation vary. *Society* may see it as a measure of equity and justice or, alternatively, as a cause of inflation and tax increases. For example, a comparison of median annual income of fully employed women

($13,014) in 1982 with that of men ($21,077) highlights apparent inequities in pay decisions.[1] Many people consider this an indication of discrimination against some society members. Society may also characterize compensation as the cause of increased taxes (wages for schoolteachers and public employees) and inflation (wage settlements negotiated by unions). Public policymakers and legislators may view income differences as guides for adjusting entitlements and transfer payments (social security, aid to dependent children, and the like).

In contrast to the societal perspective, an *employee* may see compensation as a return for services rendered or a reward for satisfactory or meritorious work. Compensation may be an indicator of the value of an individual's skills and abilities or a return for the education and training acquired. The pay individuals receive for the work they perform is usually a major source of personal income and hence a vital determinant of an individual's economic and social well-being.

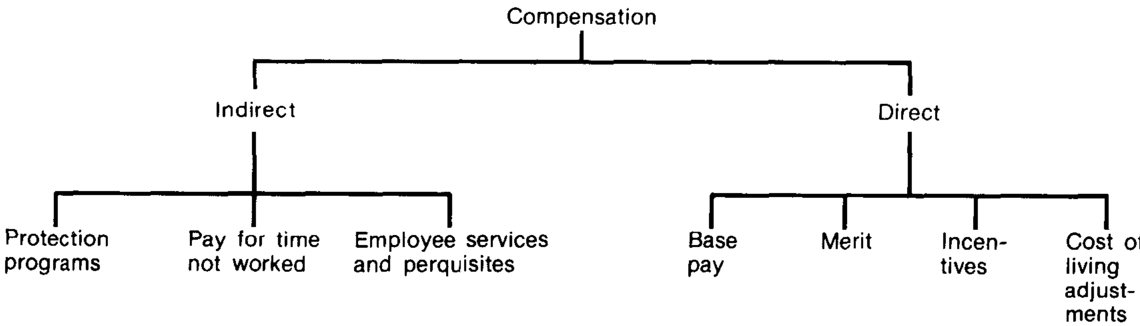
A *manager* views compensation from two perspectives. First, it is a *major expense*. Studies show that in many enterprises labor costs account for more than 50 percent of total costs.[2] Among service industries and public employers, this figure is even higher. In addition to being an expense, compensation can *influence employee work attitudes and behaviors*. It may affect an individual's decision to apply for a job, to work productively, to form a union, or to undertake more training for a new job. This potential to influence employees' work attitudes and behaviors is an important rationale for ensuring that compensation is managed fairly and equitably. These contrasting perspectives of compensation—societal, individual, and managerial—account for the relevance of the topic, but can also cause confusion if not everyone is talking about the same thing. So let us define what we mean by compensation.

FORMS OF PAY

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

Exhibit 1.1 shows the variety of forms of compensation. Pay may be received directly in the form of cash (e.g., wages, bonuses, incentives) or

EXHIBIT 1.1
Forms of Compensation



indirectly through services and benefits (e.g., pensions, health insurance, vacations). This definition excludes other forms of rewards or returns that employees may receive, such as promotions, recognition for desired work behaviors, feelings of accomplishment and the like. Such factors may be thought of as part of an organization's total reward system and should be coordinated with compensation wherever possible.

Programs that distribute compensation to employees can be designed in an unlimited number of ways, and a single employer typically will use more than one program. Pay delivery programs typically fall into five forms: base wage, merit pay, short-term incentives, long-term incentives, and employee services and benefits.

Base wage is the basic cash compensation that an employer pays for the work performed. Base wage tends to reflect the value of the work itself and ignores differences in contribution attributable to individual employees. For example, the base wage for a keypunch operator's work may be \$8 an hour, but some individual operators may receive more because of their experience and/or performance.

A distinction is often made between salary and wage, with *salary* referring to pay for those workers who are exempt from regulations of the Fair Labor Standards Act and hence do not receive overtime pay. Managers and professionals usually fit this category. Their pay would be calculated at an annual or monthly rate rather than hourly, because hours worked do not need to be recorded. In contrast, workers who are covered by overtime and reporting provisions of the Fair Labor Standards Act usually have their pay calculated at an hourly rate and referred to as a *wage*.

Merit pay rewards past work behaviors. It can be given as lump-sum payments or as increments to the base pay. Merit programs are commonly designed to pay different amounts (often at different times) depending upon the degree of performance. Thus, outstanding performers may receive a 12- to 15-percent merit increase 9 months after their last increase, whereas a satisfactory performer may receive, say, a 6 to 8 percent increase after 12 to 15 months.

Note that merit pay is defined as *rewards*. A reward is given for meritorious performance. A *return* is given in exchange for something of equivalent value. Not enough students of compensation make a distinction between rewards and returns. Some refer to all pay as rewards. Yet few employees perceive all their compensation as a reward. Rather, they tend to describe it as *returns received in exchange for labor and services* given to an employer.

What difference does a distinction between reward and return make? As we will see later, differences in employee and employer perceptions and expectations about pay and pay increases may influence the effectiveness of the pay program. Such differences in perception are one reason for the ineffectiveness of many "merit pay" programs.

Short-term incentives also tie pay directly to performance. Incentives may be offered for individual or total business unit performance or even some combination of individual and unit production. Usually very specific performance standards are required; e.g., writing $1 million worth of new insurance policies by March 1 wins a trip to Aruba. For every widget over 20 fastened per hour, an extra 5 cents is paid. Performance results may be defined as cost savings, widgets produced, quality, revenues, returns on investments or profits; the possibilities are endless.

Incentives and merit pay differ. While both may influence performance, incentives do so by offering pay as an inducement. Merit, on the other hand, is a reward in recognition of outstanding past performance. The distinction is a matter of timing. Incentive systems are offered prior to the actual performance. Sales commissions are an example; an auto sales agent knows the commission on a Cadillac versus a Chevy prior to making the sale. Merit pay, on the other hand, typically is not communicated beforehand, and the amount of money to fund merit increases is usually not known very far in advance.

Merit and incentives are clearly related. Insofar as employees begin to anticipate their merit pay, it acts as an incentive to induce performance. Thus, anticipated rewards become incentives.

Long-term incentives are intended to induce longer-range (multiyear) results. Top managers or professionals are often offered long-term incentives to focus on long-term organizational objectives, such as return on investment, market share, return on net assets, and the like.[3]

Employee services and benefits are noncash programs that include a wide array of alternative pay forms ranging from payments for time not worked (vacations, jury duty), services (drug counseling, financial planning, cafeteria support), and protection (medical care, life insurance, and pensions). These services and benefits have been increasing as a percentage of labor costs (in 1959, 25 percent; in 1982, 35 percent)[4] and are an increasingly important form of pay.

There is no single correct mix of programs for every organization and every work force. Allocation among these five pay forms may vary under differing external and internal conditions. Base wage, merit, and benefits are the most common forms, but at middle- to upper-levels of an organization, all forms may be emphasized. The compensation professional must recommend the best combination for a particular situation in a particular organization.

A PAY MODEL

The pay model shown in Exhibit 1.2 contains three basic components: (1) the concepts that form the foundations of the compensation system,

EXHIBIT 1.2
The Pay Model