



# COMPENSATION MANAGEMENT IN A KNOWLEDGE-BASED WORLD

NINTH EDITION

RICHARD I. HENDERSON

**N I N T H   E D I T I O N**

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# **COMPENSATION MANAGEMENT IN A KNOWLEDGE-BASED WORLD**

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**Upper Saddle River, New Jersey 07458**

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# Preface

The last decade of the twentieth century and the first years of the twenty-first century witnessed monumental changes in social, political, and economic systems throughout the world. This book takes a pragmatic look at one of the most controversial and critical issues facing all kinds of organizations in all kinds of political systems—that is, how to compensate employees for services rendered.

The decade of the 1990s witnessed monumental changes in the economies of the United States and the entire world. The advances in electronic-based high technology provided a strong impetus for rapid growth in the profitability and value of many U.S. businesses. Employment and employee compensation reached an all-time high. With these economic changes, many experts in human resources and compensation began promoting changes in the concepts and technologies used in the compensation world. Job analysis, job descriptions, and job evaluation were scorned as bureaucratic, old-fashioned, and obsolete. Words and terms such as *competencies*, *person-based pay*, *new pay*, *tournament theory*, *360-degree review*, and *contingent worker* became major additions to the HR/compensation vocabulary.

In the boom decade of the 1990s, labor costs spiraled out of control, and hiring excesses became common. These practices provided a foundation for the business slump of 2001 when the economies of the United States and the rest of the world began to suffer a severe decline. The boom economy of the 1990s became the bust economy of 2001, and the disaster of September 11, 2001, further accelerated the recession. Elimination of jobs, cuts in salaries, shortened workweeks, and reduction in if not elimination of bonuses became part of the world of work.

This edition of *Compensation Management* will, among other topics, take an in-depth look at the new compensation words and terms, as well as the effect of the decline in the economy on the world of compensation.

Designing and administering a compensation system that rewards employees fairly while stimulating them to provide goods and services that satisfy customer demands and permitting the organization to operate profitably is the focus of this book. Above all, this book examines the basics of compensation and now, after the tragedy of September 11, 2001, getting back to basics might prove critical to survival. This book recognizes the important role played by compensation in modern organizations. Although the book concentrates on how organizations design and administer their base pay programs for most employees, it also reviews and discusses in lesser detail what organizations are doing today to expand their base pay opportunities with incentive awards resulting from various productivity or performance measures and the complex and ever-expanding area of benefits.

Since the mid-1960s, the subject of compensation has received increased stature and recognition by all kinds and sizes of organizations. It is not unusual for even medium-sized organizations to have a director of compensation and a director of benefits. Although this book includes information about pay, incentive awards, and benefits within the field of compensation, many organizations will separate pay and benefits physically because of the different knowledge and skills required to manage both areas properly. In addition to focusing on the technologies related to the establishment of base pay programs, the book discusses and describes all the parts of a compensation system. Compensation is recognized as a broad, complex system in which organizational revenues for labor costs can be distributed in many ways. The compensation professional must be able to integrate organizational mission and policy with employee compensation demands in a manner that leads to improved organizational productivity and employee performance.

What must be recognized is that employee compensation may be as small as 10 percent of organizational expenditures, or it might consume more than 80 percent of expenditures. Whatever the percentage, no other major expenditure component has a greater influence on organizational profitability than employee compensation. This is true even for nonprofit and public-sector organizations that do not have a profit motive. These organizations must provide a wide variety of goods and services, and the quality and quantity of goods and services provided relate directly to their compensation programs.

This book is separated into three parts:

Part I provides a macro or big-picture review of compensation management and the reward system of an organization. It analyzes some of the major factors that influence compensation opportunities.

Part II contains the nuts and bolts, or microanalysis, of compensation in organizations. It includes a step-by-step discussion of the processes involved in establishing the base pay program of an organization. This part informs the reader how job requirements are identified, defined, and valued. It then describes how to recognize marketplace forces and how these various processes are integrated into a pay system.

Part III combines a macro- and microanalysis by explaining how a base pay program is expanded into a total compensation system that includes various short- and long-term incentives. It discusses the ever-increasing importance of benefits programs that not only protect employees and their dependents but provide a wide variety of lifestyle enhancement opportunities that add enjoyment and pleasure to the lives of workers and their families. It discusses how the compensation components made available to each employee are based on such criteria as membership in the organization, tenure, or seniority with the organization; responsibilities related to the job; quality of job performance and the results achieved; and overall organizational success and profitability. This part also includes an in-depth look at the short- and long-term pay and incentives offered to executives and the special compensation programs developed for employees in foreign locations.



A Model for Compensation Management: Rewarding Performance		
<i>A Macro View</i>	<i>A Micro View</i>	<i>A Macro-Micro View</i>
<i>Chapter</i>	<i>Chapter</i>	<i>Chapter</i>
1. Compensation in a Knowledge-Based Global Economy	6. Job Analysis	13. Measuring and Paying for Performance
2. The Reward System: Compensation and Noncompensation Dimensions	7. Job Description	14. Short-Term Incentives
3. The World of Pay and Compensation	8. Job Evaluation	15. Long-Term Incentives and Wealth Building
4. Organizational Structure: Strategic and Tactical Compensation Issues	9. A Point-Factor Method of Job Evaluation	16. Executive and International Compensation
5. Legislation and Compensation	10. Surveying Market Pay and Compensation Practices	17. Benefits and Services
	11. Designing a Base Pay Structure	18. Pay Delivery Administration
	12. Team-Based Pay in a Knowledge-Based World	

## SUPPLEMENT PACKAGE

The supplements to accompany *Compensation Management* have been thoroughly revised for the ninth edition. Available through Prentice Hall are an Instructor's Manual and a Windows-based Exercise Book with Interactive Software. The Instructor's Manual includes solutions to assignments, an overview of each chapter within the text, and objective questions for examination purposes. The Exercise Book contains experiential exercises, which provide the student with the opportunity to use knowledge gained from *Compensation Management* to solve real-world problems.

## ACKNOWLEDGMENTS

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**Richard I. Henderson**

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# **P A R T**



# **Macroeconomic Compensation Concepts**

## **C H A P T E R 1**

### **Compensation in a Knowledge-Based Global Economy**

## **C H A P T E R 2**

### **The Reward System**

## **C H A P T E R 3**

### **The World of Pay and Compensation**

## **C H A P T E R 4**

### **Organizational Structure**

## **C H A P T E R 5**

### **Legislation and Compensation**

The rise in importance of global markets over the last two decades of the twentieth century and into the twenty-first century has placed greater stress on organizations regarding their ability to compete and be profitable. The need to be competitive is critical to all organizations—profit and nonprofit, privately owned, or government operated. To be successful, these organizations must provide high-quality goods and services to their clients in a cost-effective manner. A major cost for all organizations in providing needed goods and services is their labor costs. This book discusses the design and administration of the labor cost function of organizations of all kinds and sizes.

Part I includes a number of discussions concerning organizational strategy. Each chapter of the book discusses a particular component of a total compensation program. The beginning of each chapter contains a brief discussion of a compensation strategy that relates to the content of that chapter. For a particular organization, the compensation strategy(ies) might have to be more specific in supporting its strategic plans.

## ■ 2 PART I Macroeconomic Compensation Concepts

Chapters 1 through 5 provide the reader with a macroview of the reward system of an organization, assisting the reader in understanding and recognizing the opportunities available to organizations to attract and retain competent workers through their compensation systems. Organizations accomplish this goal by offering employees something they want and need. The rewards provided by employers vary by kind and amount and are combined in widely different packages, but these different packages must have one common purpose—to direct employee behavior toward the accomplishment of organizational objectives and goals.

Chapter 1 focuses on the importance of money in a capitalistic–democratic society. Particular attention centers on differences in lifestyle opportunities for all members within a seven-class social structure.

Chapter 2 introduces the reader to the compensation and noncompensation dimensions of the reward system of an organization. Chapters 3 and 4 provide current and useful pay data on the earnings of employees by various characteristics, including (1) kind of job, (2) geographic location of job, (3) industry of employer, (4) competition facing employer, (5) degree of unionization, (6) government legislation regarding compensation, and (7) other major demographic criteria.

Chapter 5 focuses on the requirements placed on a reward system by legislation. In some manner, every component of the compensation system is influenced directly by legislative mandates. After completing the first five chapters, the reader should have developed a conceptual model of compensation system design and should be ready for a microview of how to design and implement the major basic subsystems that provide the foundation for a compensation system.

# Compensation in a Knowledge-Based Global Economy

## Learning Objectives

In this chapter you will learn about:

- The importance of a rapidly growing global economy.
- The relationship between labor costs and organizational competitiveness and profitability.
- The contribution of organizational compensation to the lifestyle opportunities of employees and their families.
- Income levels that determine social-class structure for inhabitants of the United States.
- The relationship among levels of education, knowledge and skills, and work-related income.

## Compensation Strategy

Develop a compensation program that recognizes the lifestyle and standard of living of all employees.

Ever since the end of World War II, social, political, and economic systems have moved toward a world economy. In the past 20 years, however, this move toward a more complex and competitive world has accelerated at a rapid pace. Today and into the future, the focus on market forces and international resource allocation will expand. Although a global economy focuses on such macroeconomic factors as inflation, gross domestic product, monetary policies, trade tariffs, and international resource allocation, one microeconomic factor has been and will continue to be of critical importance within a global economy. That factor is labor costs.

Labor cost issues affect the efficiency and even the survival of public- and private-sector organizations. Long before the advent of a global economy concept, governments in some manner developed various approaches and efforts to redistribute



income to the poorer members of their society. It has been recognized that if some kind of subsistence level of income or necessary goods and services is not provided to the poor, a belligerent society develops with constant warfare between the “haves” and the “have-nots.” One major method of providing for the poor promoted some kind of welfare payments in the form of money, food, housing, health care services, and even clothing. Another method was for government agencies—Civil Service—to provide jobs and job-related paychecks. In many countries, all kinds of nongovernment service and goods-producing organizations were stimulated to hire as many workers as possible. A major problem with these hiring practices was that many jobholders made little or no constructive contributions to the output of the hiring organization. Not only did these practices result in drastically overstaffed organizations, but the overall performance of these organizations was poor and inefficient. Providing jobs and paychecks to unneeded, nonproductive workers not only leads to overstaffing but most often results in inefficient operations and promotes cronyism and corruption.

To survive in a complex, competitive global economy, all organizations, private and public, must be able to focus on the effective and efficient delivery of the products they are designed to offer. A key factor in promoting effective delivery of essential goods and services is the provision of a performance-based remuneration system for all workers. *Compensation Management* provides a step-by-step approach for designing a remuneration system that recognizes job requirements; employee-related knowledge and skills; and performance-related incentives that link individual, team, work unit, and organization performance. Total remuneration also includes a host of benefits that protect and expand the lifestyle and health of workers and their families. The total of these contributions by the organization represents its labor costs. On the one hand, these costs should contribute to improved employee performance and, on the other hand, expanded productivity so that an organization can be competitive and profitable in providing its goods and services within a global economy.

## CAPITALISM AND KNOWLEDGE IN A GLOBAL ECONOMY

It is not often that world events have a major influence on organizational support operations. With the fall of the Soviet empire and a worldwide decline in communism, however, interest in capitalism has risen to an all-time high. The political-social-economic battle between capitalism on one side and communism-socialism on the other side has focused renewed worldwide attention on jobs, employee income from job-related efforts, organizational profitability, ability to compete in global markets, and income distribution in the United States and throughout the world.

To gain appreciation of the influence of these worldwide events on the role of compensation professionals and managers, it is helpful to start with a brief explanation of capitalism and the dynamics that support it as a viable economic solution to global problems. A critical factor underlying capitalism as an economic theory is that profit is OK; it is neither wicked nor unacceptable to make money. For capitalism to succeed, however, a strong, direct, and supportive relationship must exist between work and the monetary rewards available through work. Today, more than ever before, there is recognition all over the world that if an organization is to succeed, it must have a motivated workforce that receives joy from working and is dedicated to successful opera-

tions. In a capitalistic world, employees must respect money and the challenges of their work to gain satisfaction from work performed.

The move of capitalism into a knowledge-based world centers attention on an enlightened society. The importance of knowledge demands a predisposition toward continuous self-improvement. To be successful in a knowledge-based capitalistic world, a passion for learning must exist that includes a recognition of the need for education.

A major problem facing the United States and its leadership role in a capitalistic-democratic world is an increasing and unacceptable difference between the income of the lower-paid and the higher-paid members of the workforce. The growing disparity of income between the lower-income and the higher-income members of society relates directly to the increasing influence of higher levels of knowledge and skills in pay determination. Those members of society who do not have an adequate or acceptable level of education are going to find themselves in an unenviable position regarding current and future income opportunities. The pay and compensation for those with acceptable levels of knowledge and skills will rise, whereas those with minimal levels of required knowledge and skills will see their income opportunities stagnate, or even decline.

More than ever before, the compensation professional must be able to support all activities that will make the organization more successful. In the past decade, widespread activities have reduced the size of the workforce—downsizing or reduction in force (RIF), and the elimination of entire levels of management structure, called reengineering. These efforts have been successful in decreasing organizational costs and increasing profitability. For some employees, it has meant increased workloads with minimal to no change in pay. For others, it has meant the loss of well-paying jobs.

From the beginning of these organizational redesign efforts, compensation professionals have been called upon to identify (1) jobs in which worker efforts can be combined, (2) unneeded jobs, and (3) possibly jobs in which incompetent, obsolete, or unneeded employees are being hidden. In addition, these same compensation professionals are being asked to redesign compensation and reward programs to improve employee morale and motivation while keeping labor costs within specified limits.

To assist their organizations in competing while functioning within these often-conflicting requirements, compensation professionals have had to increase their knowledge and skills dramatically. Because of these advances in knowledge and skills, the importance of the compensation profession has risen in the managerial-professional world.

## COMPENSATION AND ORGANIZATIONAL STRATEGY

To develop a competitive advantage in a global economy, the compensation program of the organization must support totally the strategic plans and actions of the organization. The individuals occupying the executive positions of the organization are responsible for establishing and developing the strategy of the organization. The overall strategic plans inform all of its members of the direction the organization wishes to take. Management and organizational specialists review these strategic plans and take the actions necessary within their domain to ensure accomplishment of the plans.

For the human resources/compensation specialist, the assignment to ensure accomplishment of organizational strategy begins with determining (1) the work that must be performed by some work unit or individual, (2) the kinds and levels of knowledge